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THE DEVELOPMENT OF FOREIGN TRADE IN THE BALTIC COUNTRIES-

The potential of trade with the United Kingdom and the United States

Karin Larson & Jenny Wikström

Graduate Business School
School of Economics and Commercial Law
Göteborg University
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ABSTRACT

Since their independence in 1991 Estonia, Latvia and Lithuania have struggled to transform into market-oriented economies. During a decade, the Baltic countries have accomplished an impressive reorientation of foreign trade, and today the EU represents the most important trading partner of the Baltics. However, foreign trade is still far from fully developed, which leaves opportunities for new foreign actors to participate and affect the growing trade volumes of the Baltic countries.

The main purpose of this thesis was to investigate the further development of the Baltic countries' foreign trade with special consideration to trade partners with the potential of reloading goods in Göteborg. The findings of the study are based on statistical data as well as on a field-study in Estonia where important export companies and trade organizations were interviewed. It was concluded that a number of factors could have an impact on the development of trade such as the world recession, membership of the EU, the development of trade with Russia and the development of industry structures. The results indicate that even though there are further potentials of trade with the United Kingdom and the United States, this potential is not very significant within the next 5 years.

***Key-words*: Foreign trade, exports, imports, development, Baltic countries, transition, the United Kingdom, the United States.**

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1. INTRODUCTION

This chapter serves as a background for the whole thesis and is supposed to put the reader directly into the core subject of the study. The chapter begins with a background to the main problem whereupon the problem is discussed and defined. Finally, at the end of the chapter the Port of Göteborg AB, who is the assigner of this thesis, is shortly presented.

1.1 RESEARCH BACKGROUND

The fall of the Soviet Union a decade ago has completely altered the world map and resulted in a number of new independent states. These states all struggle to transform into fully fledged market economies, a process that has proved lengthy and complicated. With Western eyes these markets provide great opportunities for business and trade although the business environment simultaneously involves enormous risks and complexity.

After fifty years of communism within the Soviet Union, the three Baltic countries regained their independence in 1991. This was the starting point of a long transition period towards a market economy that is still far from being completed. During the last decade the Baltic countries have achieved impressive progress of transition. An extensive number of market oriented structural reforms have been introduced and their industries have been liberalized and opened up to international trade. Their development has so far proved to be a success. By 1997 growth in the Baltics was among the fastest in the transition economies. However, although the three countries had similar starting points they chose different routes of transition, resulting in some divergence in their economic development. Clearly, Estonia seems to have been the most successful and western-oriented state while Lithuania in particular has been lagging behind. The countries were all severely affected by the Russian crises in 1998, which put an end to fast growth. Nevertheless, in recent years the Baltic countries seem to be back on the track to sustainable growth although

the current world recession naturally presents a highly uncertain element for their further development.

One central factor of a transition country's development is the progress and growth of foreign trade. The opening towards other markets has been a vital source of economic growth but has also been an evidently difficult task. Estonia was especially early with its liberalization of foreign trade, which has later proved essential for its further development. Economic growth in the Baltic countries is largely dependent on a positive growth of exports. This was especially evident at the beginning of the transition process when domestic demand was particularly weak. Recently, economic growth has been increasingly built upon a stronger domestic demand in especially Latvia and Estonia. Nevertheless, foreign trade will remain a significant factor of economic growth due to the small sizes of the Baltic economies.

1.1.1 PROBLEM DISCUSSION

A brief explanation of foreign trade planning under communist rule is necessary, in order to fully comprehend the preconditions and development of foreign trade in the Baltic countries. In the Soviet Union foreign trade was planned as any other economic activity. Foreign trade acted as an instrument to adjust the balance for materials, and was considered secondary to domestic trade. As opposed to the market-oriented view where the aim is to reach a positive trade balance exports represent a larger trade value than imports and thus generate value for the state, the intention of a state planned foreign trade was quite different. Imports were more important than exports since importing had the aim of balancing the lack of domestic goods, and exporting was therefore primarily used to make up for the losses in money due to imports. Additionally, the inconvertibility of these countries' currencies consequently led to a number of obstacles in the foreign trade. Accordingly, at the starting point of transition, foreign trade had a long way to go before reaching the levels of Western countries trade. (Lavigne, 1999)

The Baltic States have all experienced considerable growth in exports since the beginning of the 1990's. Foreign trade has changed completely, from total

dependency on the former Soviet Union to becoming increasingly western-oriented. Today, the largest trading partner for all three countries is the European Union, where Finland, Sweden, Denmark, Germany, and the United Kingdom are especially important. However, imports have increased at a much faster pace than exports resulting in large foreign trade deficits, creating a major weakness for the Baltic area. Estonia has overall had a higher share of exports as well as more advanced products compared to its neighbors Latvia and Lithuania although the differences between the countries are steadily decreasing.

Naturally, the fall of the Soviet Union completely changed the prerequisites for the Baltic region's foreign trade and its ports (Ventspils, Liepaja and Riga in Latvia, Tallinn in Estonia, and Klaipeda in Lithuania are the most important ones). Earlier the ports handled the foreign trade of the Soviet Union, with the fall of communism came privatization forcing the ports to compete both internally within the Baltic region, and with the rest of the world. This required increased efficiency and market planning. Today, the Baltic countries' central geographical location gives them a great advantage and their ports play an important part in the east-west transit trade and are an essential income source in the state budgets of these countries. The Baltic ports are, for instance, still of importance as an outlet for Russia's foreign trade with the West. (Brodin, 2000)

Yet, the foreign trade of the Baltics is still far from completely established, which gives enormous potential for further growth. Even though the growth rates have been impressive so far, and assuming that growth will continue to be high, the levels of foreign trade in the Baltic countries are far from being comparable to the levels of a Western country. The future expansion of foreign trade in this area involves varying alternatives considering trade partners and commodity groups. The future development of the foreign trade of the Baltics is of course difficult to predict. The question is whether the trade will deviate more towards Central Europe, whether it will remain focused on basically the same trading partners as today or whether trade with the United Kingdom and the United States (a more western-directed trade) will increase to a large extent in the near future. In any case, the progress in the Baltic countries gives many

opportunities for new foreign actors to participate in, and to affect, the growing trade volumes. All ports in North-Western Europe have possibilities to take part in this development. One potential actor could be the port of Göteborg, acting as a hub for the Baltics' foreign trade to certain countries in the west. The main reason for the interest of the Port of Göteborg to take part in the foreign trade of the Baltic states, is the obvious opportunity to offer a competitive integrated transport solution cross Sweden to and from partners that are suitably geographically located, e.g. British Isles and the Americas.

1.2 PROBLEM DEFINITION

Based on the discussion above the main research focus of this thesis has been identified and reads as follows:

MAIN PROBLEM

> How large is the foreign trade potential of the Baltic countries in the near future with special attention to trading partners whose location gives most opportunity for reloading goods in Göteborg?

In order to investigate this problem, two extended research problems have been established that will facilitate the examination of the main focus. The first research problem is concentrated on the collection and analysis of statistical data regarding the development of foreign trade in the Baltic countries aiming at finding any patterns or trends that could be essential for the further progress of foreign trade. The second research problem investigates the contemporary environmental elements that have been considered to have a certain impact on the outcome of foreign trade in the near future. Together, these two research problems provide the statistical and real-life context for the prediction of the foreign trade potential.

Research Problem 1:

How has foreign trade developed in the Baltic countries since the fall of the Soviet Union in terms of goods and trade partners with special attention to the United Kingdom and the United States?

Research Problem 2:

What external and internal factors could influence the further development of the foreign trade within a five-year period?

1.3 PURPOSE

The purpose of the thesis is to predict the development of foreign trade in order to investigate the possibilities of the Port of Göteborg AB in becoming an increasingly important part of the foreign trade of the Baltic countries.

1.4 DELIMITATIONS

- The study is limited to enclose only trading partners where the Port of Göteborg AB has evident opportunities to provide efficient trade services. Based on a judgment of the most obvious geographical destinations from the perspective of the Port of Göteborg, the United Kingdom and the United States have been selected as the primary targets in the prediction of foreign trade.
- Furthermore, the study does only include goods that are containerized. Consequently, raw materials such as oil and minerals, will not be taken into consideration.
- Transit trade to and from the Commonwealth of Independent States as well as Asia and the Transsibirian land area has not been taken into account with respect to this study.

- The forecasting of foreign trade has been limited to a period of five years.
- Since this thesis is part of a broader project, assigned by the Port of Göteborg AB, this study will neither include transport-economic calculations of any kind nor an internal analysis of the Port of Göteborg. These subjects will be treated by other thesis groups.
- The field study is limited to Estonia.

1.5 THE PORT OF GÖTEBORG AB

"*Port of Göteborg AB shall load and discharge cargo and develop customer-oriented transport solutions that will direct cargo via the Port of Göteborg AB*". –Business concept of the Port of Göteborg AB

The Port of Göteborg AB is the largest port in Scandinavia and an important hub for Scandinavian trade and industry with destinations in Scandinavia, Continental Europe, Great Britain, North and South America, Australia, New Zeeland and Asia. Its geographic location provides an excellent advantage and facilitates the reach to a broad number of destinations including North, West and East Europe including the Baltic countries. Further, the port provides an incredibly well developed infrastructure with frequent connections to the neighboring countries, Germany and the United Kingdom and a wide railway network and road connections. Direct sailings to North America and the United Kingdom departure several times a week. The port is a limited company owned by the City of Göteborg, with a turnover of 1,1 billion SEK in the year 2000 and about 1000 employees. (www.portgot.se)

During the past years, the port has been growing immensely and today more cargo than ever is shipped through Göteborg to be further transported by ship, railway or truck. In 2000, 30 million tons were transported, which is an increase of 9% since 1999. The most common cargo is oil, which constitutes close to 2/3 (19,3 ton in 2000) of the total amount. General cargo amounted to 13,6 ton in 2000. The remaining cargo is other bulk than oil, which only represents a very small part of the total cargo in 2000, 0,2 ton. Within 10 years,

the Port of Göteborg expects to double its container and trailer capacity. However, to attain this goal and to keep its position as the foremost port in Scandinavia, the port needs to improve its handling space, machinery and infrastructure. Several substantial investments are planned for the future including the improvement of channels and the extension of container capacity. (www.portgot.se)

Of course, it is of interest to the Port of Göteborg to obtain a share of the future trade flows to and from the Baltic region. The sooner the port could establish close and long-lasting customer relationships, the greater the possibilities to become a significant participant in the Baltic foreign trade. The Port of Göteborg could develop into an important center for the reloading of goods for further transfer to destinations world-wide, especially for a more western-directed trade. Thus, the port has every reason to take an increased interest in the further development of this trade. However, the aim of this study is not to evaluate the potential customer base and thus whether Estonian exporters are interested to export their goods through the Port of Göteborg. Rather, this thesis will investigate the overall current and potential of foreign trade from and to the Baltic region.

Fig.1 Possible trade routes cross Sweden and the Port of Göteborg

Source; www.encarta.msn.co.uk

2. METHODOLOGY

The purpose of this chapter is to present and motivate the chosen scientific approaches as well as to pinpoint any shortcomings of the study. The intention is partly to give the reader an opportunity to evaluate the scientific value of the research but also to give an insight into the considerations of the researchers.

2.1 RESEARCH APPROACH

2.1.1 QUALITATIVE RESEARCH

This thesis aims to give an indication of the foreign trade development in the Baltic countries. The ideal case would therefore be to carry out a close and in-depth analysis of the inquired companies but at the same time keep the number of inquired companies as extensive as possible. Thus, in this case, both a qualitative and a quantitative research method should have been considered. Consequently, the aim has been to combine the two research methods to obtain the benefit of both. In order to gain a general background and a basis for analyzing foreign trade, the empirical study begins with a quantitative research method, acquiring statistical foreign trade data. However, there is reason to believe that only using a quantitative method could not solve this specific problem, since a deeper and closer study of the research objects is needed to provide the outmost understanding and solution to the chosen problem.

In qualitative research one of the main characteristics is to involve the participants´ perspectives of the research problem rather than that of the researchers. Opposed to a quantitative method, which investigates parts of reality, a qualitative researcher studies the creation of the parts in becoming a whole. Since reality is dependant on people's subjective perceptions of the world there are in fact many realities and thus, it is essential to understand people's individual ideas about the world in qualitative research. (Merriam, 1998) Thus, since the research problem concerns the prediction of foreign

trade, the analysis is facilitated by a qualitative research. The premonitions of the respondents based on their experiences give more extensive in-depth discussions that result in improved prognosis of the future compared with what a quantitative research can accomplish by itself. Consequently, the balance between a quantitative and a qualitative research give the ultimate prediction to the research problem.

The chosen subject of research has been given a more inductive rather than a deductive approach, because the existing frame of reference is not extensive enough to cover the complex research problem. According to Merriam (1998), an inductive research strategy is closely related to a qualitative method since qualitative studies are frequently carried out when the existing theory is inadequate to explain a contemporary phenomenon. However, research is seldom purely inductive since studies are always derived from existing knowledge that is analyzed and interpreted in numerous ways. (Merriam, 1998)

2.1.2 CASE STUDY

With the intention of achieving a comprehensive understanding of the research problem a case study has been conducted. The reasons for choosing this particular research strategy are several. The field of research, i.e. the penetration of the Baltic's foreign trade, is a complex problem over which the researcher has limited control that is most suitable to study in its real-life context. Instead of focusing only on the foreign trade development of the Baltic countries, the economic environment is also considered important for foreign trade because it highly affects its development. In other words, an attempt has been made to study a phenomenon in its wider context to gain a more holistic view. Due to the fact that several different companies and organizations are included in the study the research can be referred to as a multiple-case study. The purpose is to increase the variation to make the interpretation more convincing and thus, enhance the level of generalization. (Yin, 1994)

2.2 DATA COLLECTION

2.2.3 PRIMARY DATA

2.2.1.1 Interviews

In accordance with the selected research approach, the empirical study has been based on personal interviews with a number of foreign enterprises and organizations in Estonia. Personal interviews were chosen to receive a deeper commitment from the respondents since eye-to-eye contacts generally tend to reveal more detailed and extensive answers. In addition, personal interviews leave greater opportunity to respond more freely to questions, but it also facilitates the avoidance of uncertainties regarding the question. Thus, personal interviews seem to be the most appropriate method of data collection in this case to achieve the expected results.

A vital consideration when choosing case companies in a qualitative research is how to delimit the selected population. The primary demands for the selection of companies were that the companies should have foreign stakeholders, export an extensive share of their total production and belong to the largest export enterprises in Estonia. Additionally, the selection criteria included finished manufactured and basic manufactured goods that can be transported in containers and thereby excluding raw material such as oil products and metals. Thus, the selected enterprises should primarily export goods that are suitable for reloading at ports. The aim was also to cover the most important industry sectors in Estonia, including machinery and equipment, wood and textile. The number of companies was restricted due to the limited period of time, in this case one week, when the interviews had to take place. Other delimitations concerned the possibilities to travel to certain places as well as the possibility to conduct interviews in English. Due to limited time and traveling options, but also because contacts were easier to establish in Estonia, Latvia and Lithuania have been excluded from the field study.

Finally, the chosen case companies include Krenholm Valduse AS, Baltex 2000, Flexa Esti AS and AS Tarkon. In addition, a number of organizations were interviewed to further supplement the picture of the internal economy and

foreign trade in Estonia. These include Estonian Chamber of Commerce and Industry, Estonian Investment Agency, Estonian Trade Promotion Agency and Swedish Trade Council. Moreover, interviews were conducted with Holmen Mets and the Port of Tallinn. Holmen Mets is less relevant for our study since it turned out to be a trading company, supplying raw material for its parent company in Sweden. The Port of Tallinn has only been used as an input for further information about foreign trade in Estonia and its future capacity to handle exports and imports. Consequently, both Holmen Mets and the Port of Tallinn have been treated less extensively compared to the other case companies. The respondents, who represented these case companies, have been listed in the bibliography at the end of this thesis.

2.2.1.2 Statistical Data

In order to receive a foundation for the prediction of foreign trade, statistical data of the development of foreign trade from 1993 to 2000 has been collected and analyzed. This data is presented in an extensive number of graphs. Firstly, foreign trade with different countries is demonstrated, using the International Monetary Fund (IMF) as the source. IMF data are based on the national countries' own statistics. IMF has been considered as the foremost source for the first part of the study since it covers a wide time period and all the relevant trading partners. However, it does not include a division of commodity groups on specific trading partners, which made it impossible to use IMF for the whole study.

Thereafter, the focus was turned to the most relevant trading partner for the future with regard to the location of the Port of Göteborg. The United Kingdom and the United States were chosen as potentially important destinations of Baltic trade. Based on the SITC system the statistics was divided into three different commodity groups, raw materials including group 0-4 in the SITC system, basic-manufactured goods (SITC 5-6) and finished manufactured goods (SITC 7-8). The most interesting goods for the Port of Göteborg are of course the basic manufacturing and the finished manufacturing as these goods are easier to reload. The purpose is to gain an overview over what group of goods that are currently exported to the previous mentioned destinations.

Under the circumstances, the conclusion was that the Organization for Economical Cooperation and Development (OECD) statistical database provided the best available source. The negative aspect of this database is the fact that it is provides reversed data, that is data derived from the perspective of OECD members and thus, not from the Baltic countries own databases. Another difficulty with OECD is that it proved to comprise transit trade from Russia, which further complicates the comparison due to misleading data. The reason is that transit trade, including mainly raw materials such as oil and oil products, result in the wrong proportions between the commodity groups and generally a much-overvalued share of raw materials. The statistics from the national countries naturally excludes transit trade since it is originates from Russia while some international sources include such data. Thus, the first attempt to use the UN Comtrade database together with the national databases proved impossible, giving unreliable and incomparable data. Only using the national statistic databases was impossible due to missing data of especially Lithuania. Additionally, national statistics of the Baltic countries uses a different grouping of goods, instead of the SITC system, which could result in difficulties to compare the data correctly. Therefore, OECD was the best solution for this study. It gives a complete picture of the data from 1993-2000 and uses the SITC system. However, as a result of the main problem of the OECD concerning transit trade, raw materials have been excluded from this study.

Furthermore, the study also includes graphs based on quantity instead of value. The purpose is to gain as realistic and broad picture as possible. Quantity is also interesting for the Port of Göteborg, since it provides a more relevant picture from a transportation point of view. The collecting of quantity data proved very problematic. Few international as well as national sources seem to encompass quantitative data. Finally, the choice was limited to the OECD database, which unfortunately only covers the year 1995 to 2000 and concerning the United Kingdom data is only available from 1995-1999.

2.2.2 SECONDARY DATA

In order to get a broad picture of the already existing theory on this subject, an extensive amount of data has been gathered from a variety of different sources such as articles, books and the Internet. Since the main problem of this thesis is very specific and concerns a prediction of the future, there are no existing theories that exactly correspond with the problem. As a result, the secondary data and theories used in this study are partly related to the problem, and together serve as a basis for the continued empirical findings and analysis.

2.3 QUALITY OF THE RESEARCH

2.3.1 VALIDITY

Internal validity concerns whether the researchers have measured what was supposed to be measured or if the findings could have been influenced by other factors. Additionally, internal validity deals with the extent to which the findings relate to reality and if the results can be considered to be credible. (Merriam, 1998)

The measured problem refers to a forecast of foreign trade of the Baltic states and what factors that could have an impact on this development. From the collected statistical data and the performed interviews enough data has been gathered to be able to provide as equitable picture as possible. The reason to use interviews to gain the information needed to solve the problem was to gain a broader context and background. Conducting a quantitative research would have limited the understanding and would only have provided the study with basic facts. In order to conduct a forecast, it is imperative to understand the background that these facts are built upon. Thus, the interviews gave a thoroughly understanding of the problem.

The quantitative research enhanced the basic comprehension of foreign trade, simplifying the statistical scenario building. The interviews are thereafter used as a complement to increase the credibility of the prediction. The combined

result of using both quantitative and qualitative methods should therefore be considered as an advantage for the outcome of this study.

External validity concerns the study's possibilities to be applied to other situations, meaning that companies other than the case company might benefit from the results. In order to reach general conclusions the research must have a high degree of internal validity. An advantage of this study is that more than one case company has been included. Multiple case studies increase the level of external validity or generalization since an investigation of more than one similar and different case companies contributes to widen the scope. Hence, the interpretation of the received information can be generalized with more certainty. (Merriam, 1998) However, the number of companies is far from representative for the total number of export companies in Estonia, and a more extensive research would, of course, have resulted in an increased degree of generalization. The chosen cases are still among the largest export companies within their respective industry sectors in Estonia and must therefore, to a certain degree, be considered as representative for the total population. Additionally, to improve the external validity the research also includes a number of organizations with expert knowledge in the foreign trade area.

Because the field study was focused on Estonia, there are of course some doubts about the extent to which the results from the interviews also could apply to Latvia and Lithuania. However, since Latvia and Lithuania are relatively similar to Estonia there is still a certain possibility for generalizations regarding the Baltic countries total foreign trade potential. A comparison between the countries is conducted in the analysis in Chapter Seven.

2.3.2 RELIABILITY

Reliability refers to the extent to which the study's results can be replicated and consequently if another researcher with the same preconditions would reach the exact same results. In qualitative (case study) research however, this is generally not possible due to the researchers subjective interpretations. Accordingly, reliability in qualitative research deals more with whether the results are consistent with the collected data. Qualitative research cannot avoid

having a certain degree of subjectivity, namely the researchers thoughts and ideas. However, it is still possible to evaluate whether the results of the study and the information gathered seem reliable, trustworthy and reasonable. (Yin, 1994)

Considering personal interviews, this method of data collection can be said to have limited reliability since the questions are seldom very standardized and the answers are also often tied to a specific point in time. Both the researchers own subjectivity and preconceived ideas might have an impact on the respondents as well as when analyzing the material. However, the interview questions have been carefully constructed in a way that the questions are not leading but should rather serve as a base for discussions. The interview guide was structured in a number of fixed points, which served as a template for the interviews. The purpose with the template was to open up for more extensive and in-depth discussions leading to a more informal environment.

Additionally, the received information has been analyzed with great awareness that should increase the degree of reliability. In order to decrease the subjectivity of the researchers and improve the documentation, a tape recorder was used during all the interviews. The general apprehension is that the respondents were considered open minded and trustworthy. Another weakness of the research is that only one person at each of the case companies was interviewed. As a result one person represents the entire company, which might not give a reliable view of the company as a whole. Nevertheless, the interviewed were all among the top management in respective company and should thus be considered trustworthy. Additionally, by interviewing several organizations the objectiveness should have been improved since they should have a broad knowledge and experience that should make them as objective as can be expected.

Regarding the reliability of the statistical data, international sources have been used. However, concerning certain international sources (OECD and UN) it is not to be expected that what one country reports as its import value should correspond perfectly with that which is reported as exports by its trade partner. A deviation of about 20-30 percent is usually accepted as normal. (Brodin,

2000) In the case of Swedish foreign trade with the Baltic states the Swedish side tends to set a higher value of the goods imported compared to the goods exported from the Baltic states. In the international sources transit trade originated from Russia, is usually classified as exports from the Baltic states, which gives a misleading picture over the Baltic foreign trade. This also explains the great differences between Swedish import data and Baltic states export data. (Brodin, 2000)

The choice of OECD as a source could therefore decrease the degree of reliability. However, since transit trade mainly deals with raw materials it should not have a vital affect on the study as such. Another shortcoming of OECD was the lack of data for the United Kingdom in 2000. In the year 1999 trade experienced a downturn due to the Russian crisis, and therefore the numbers may not be comparable with the year 2000. The choice of OECD as a source could of course be questioned. Nevertheless, in comparison with the other options available OECD still seemed advantageous. As previously discussed, the national sources have their own disadvantages and it is essential to carefully evaluate the benefits against any shortcomings. The choice of trading partners presented in the graphs is based on an evaluation of importance and relevance from the perspective of the port of Göteborg. However, to increase the level of comparison, the same trade partners were chosen for all three countries. Therefore, some trading partners might have been disregarded since they were not considered vital for this study.

The factors chosen to serve as a basis for the analysis; economical factors (including world economy), membership of the European Union, investments in Estonia, the development in Russia, Latvia and Lithuania and the development of industry sectors, were not selected using any selection criteria. Rather, the factors are a result of the collected material on forecasts on the Baltic states economy and trade, the researchers' brainstorming and derived from discussions during interviews. The degree of relevance for the prediction of foreign trade concerning these factors might differ from factor to factor. In general however, these factors should provide a broad picture of the development in Estonia and therefore also for the development of foreign trade. Yet, it should also be noted that these factors are by no means exclusive for the

development of trade and that there are other possible determinants not included in this study.

3. THEORETICAL FRAMEWORK

Four main theories have been selected to provide as a basis for this study; transition theory, internationalization theory, international trade theory and transport-economical theory. The future development of foreign trade in a transition economy is clearly not a well-established research area and there are no evident theories to apply upon this subject. Therefore, an eclectic approach has been applied to the theoretical framework of this thesis and the different theories above are chosen since each provides a part of the understanding of the development of foreign trade in the Baltic countries. The theories will accordingly not be used as a basis for the analysis chapter or be as extensively analyzed, as usually would be the case in other academic studies. Rather, each theory will provide an insight to the preconditions and circumstances under which foreign trade develops in the Baltic countries.

3.1 TRANSISITION THEORY

3.1.1 WHAT IS A TRANSITION ECONOMY?

The word "transition" generally means a changeover, from one point to another. In today's emerging markets of Central and Eastern Europe, transition refers to the radical change of a country from a centrally planned economy to a decentralized market economy. Many researchers refer to the state of a transition economy as being "a non-planned, non-market economy", thus an economy caught up in between two systems moving from one to the other still having parts of the two systems operating simultaneously side by side. Hence, in this sense the meaning of transition is often characterized by a chaotic and uncertain state of mind. (Golubeva, 2001)

The main components of the transition towards a market economy include:

- Macroeconomic stabilization, using monetary and financial devices to control macroeconomic indicators such as the rate of inflation and the interest rates as well as to balance the government's budget.
- Liberalization, including liberalization of prices as well as of domestic and foreign trade.
- Privatization, restructuring and structural reforms including a reform of the banking and financial sectors, the development of a legal framework, a social safety net development as well as an industrial policy. (Lavigne, 1999)

The main goals of transition are, according to Roland (2000), first of all to improve allocate efficiency which is accomplished through price liberalization and the opening of the economy to the world markets foreign trade liberalization. Secondly, macroeconomic stabilization is necessary to make the price system function correctly. Thirdly, restructuring of state companies to make them work in a market economy is mainly accomplished by privatization. Finally, there is a need for a political and institutional stability. Obstacles in achieving these four goals are, for example, the general uncertainty of the outcomes of the reforms, the way the different reforms interact and complement each other on the way and political oppositional groups and a willingness to return to the old system that can occur due to an overall discontent among the population of the outcomes for example the fall in output of the transition. (Roland, 2000)

Although there may be an overall consensus when it comes to the objectives of the reforms of transition, there have been many controversies among experts regarding the speed and sequencing of the reforms. The transition from a socialist economy towards a market economy was a completely new experience, which has resulted in a number of unexpected events and it can therefore be concluded that it is complicated to compare the paths taken by different countries in transition. The contradictory results of countries are a result of the differences in initial (economic) conditions and in political constraints in the countries although it can also be the result of an incorrect choice of the strategy of reforms. (Roland, 2000)

3.1.2 THE SPEED OF TRANSITION; "BIG BANG" VS. GRADUALISM

One of the most important issues and focuses during the transition has been the question of the speed of the process. As Poland gained independence and entered the transition process it undertook a route towards a market economy that has later become famous as well as fiercely investigated and discussed. The Polish direction of development has commonly been known as "shock therapy" or "big bang". As a result of the fact that Hungary chose an opposite path of transition, later called "gradualism", there were initially at the beginning of the 1990's disputes over which way was the ultimate one to take. (Lavigne, 1999) Additionally, besides these two radical groups another group of researchers emerged in the middle of the other two, emphasizing the need for shock therapy for some part of the reforms and gradualism for other parts. (Roland, 2000)

Undertaking a "shock therapy" refers to a simultaneous implementation of reforms at all levels of society including currency convertibility, the elimination of subsidies, liberalization of prices and trade as well as privatization of industry (Portes, 1993). Thus, a "big bang" generally expresses eagerness to completely break with the past and hence, exclude any possibilities to return to what once were. The results were a steep decline in the standards of living and output but this decline was supposed to be relatively short and the recovery fast. (Lavigne, 1999)

On the other hand, a gradualist approach to transition suggests that cautiousness and implementing changes step-by-step is much wiser since this would soften the shocks and result in a lower, but on the other hand, prolonged recession period. Gradualists argue that a shock therapy cannot apply to structural reforms since these take a longer time to implement; privatization or reforming the entire banking system in a country is impossible to obtain in a short period of time. Additionally, the same benefits could occur at a much lower cost if the reforms are introduced gradually. (Norgaard, 1996, Lavigne, 1999)

Of course, shock therapists oppose these opinions meaning that the efficiency of structural transformation is only enhanced by a fast stabilization. Moreover, the social costs of transition have in fact not been proved to be higher when conducting a shock therapy as opposed to a different approach. Opponents of gradualism also present the fear that a slower path of transformation will give oppositional forces time to put an end to the reform. The gradualists on the other hand implies that there is a greater fear that a shock therapy will result in such large and instant social costs that a political reaction eventually will end the reform. (Norgaard, 1996, Lavigne, 1999)

Åslund (1993) belongs to one of the most enthusiastic advocates of shock therapy. Together with other famous shock therapy advocates like Jeffrey Sachs and David Lipton, he strongly believed that the best long-term results are achieved through concentrated simultaneous changes. He presented a number of important arguments in favor of a quick transition.

First of all, there was a broad agreement among macroeconomics at the beginning of the 1990's that after a very high inflation rate, macroeconomic stabilization can only be realized through a package of simultaneous, fast and radical measures. These radical measures are necessary to obtain credibility and to break the inflation expectations. Furthermore, since there is no similarity whatsoever between a planned economy and a market economy, a quick transition with a consistent new economic system avoids the difficult position in between the old and the new system. Thirdly, Åslund claims that macroeconomic stabilization works as the very foundation for microeconomic restructuring. Companies will consequently not restructure nor adapt to a new environment until they are forced to under the exposure of harsh budget constraints. Such budget constraints can only be realized through a strict macroeconomic stabilization at all levels. A fourth argument is that foreign trade must be liberalized simultaneously as other measures, since foreign competition is crucial for the creation of a functioning market economy. There is also reason to believe that corruption is especially significant during the transition period, thus, making this period as short as possible should diminish this problem. (Åslund, 1993)

Furthermore, introducing a complete package to the parliament generally facilitates the implementation of the stabilization measures. Swiftness gives the politicians less time for discussions and accordingly less time for oppositional forces to put an end to the reforms. Rapidity also increases the credibility of the transformation. Generally, it is easier to accept changes at the beginning of the transition period before the negative social affects of the change of economic systems will become evident. Additionally, if reforms are introduced gradually, the old communists will act as impediments towards radical changes, due to their ignorance of western economy. Hence, the faster the transition, old knowledge will more obviously prove to be obsolete and redundant. (Åslund, 1993)

Also, the shortage of statistical information is especially bad and difficult to interpret during a change of systems. Therefore, a gradual and prolonged transformation would undoubtedly only worsen the lack of information. Finally, it is absolutely vital that private companies and market relations are introduced quickly to stimulate the further development of the market economy. (Åslund, 1993)

Although opposing most of the ideas, Åslund (1993) also presents the most important arguments for a gradual transition. First of all, advocates for a gradual introduction of reforms usually tend to emphasize the argument that restructuring is a prolonged process, which cannot be implemented over night. Especially foreign trade has been recommended to be deregulated gradually. There is furthermore a danger for mass unemployment with shock therapy. (Åslund, 1993) Valtr Komarek emphasizes the time factor as especially significant in opposing a rapid development. He questions the possibility for Eastern Europe to precede this fast and states that they need the same preparation for international competition as the West European institutions needed to develop in the past. Hence, the domestic industries initially need protection against external competition in order to develop properly. Consequently, overall the shock therapy approach instantly eliminates the role of the government in the economy and Komarek questions how any country could survive such a shock. (Portes, 1993)

Furthermore, it has been argued that the social costs would be too high with a rapid implementation of changes. Additionally, it is likely that the economical recession would be more profound as a result of a shock therapy and thus, that a social explosion would be the result. It has also been claimed that it is impossible to conduct such vast modifications rapidly and hence, that these sorts of transformations need time and not speed. A fifth argument point is the fact that the learning process of human beings is by nature a long and complicated phenomenon that cannot be forced upon in a rapid manner. Thus, a rapid transformation would only be naturally hindered by the human factor. Finally, it was initially also argued that the people of a former socialist nation are so immensely affected by socialism and accordingly have so little knowledge of capitalism that it will be very difficult for them to accept and adjust to the general laws of this society. Consequently, the inequalities of, for instance, the wage system will not be easy to accept and the basic understanding of how to run a business is fiercely damaged. (Åslund, 1993)

However, nowadays it has been recognized that macroeconomic stabilization should in fact be conducted rapidly whereas structural reforms can be realized gradually, over a longer period of time, which puts the most desirable path of speed in between the original two approaches. (Lavigne, 1999) Additionally, it has afterwards been argued that focusing on the speed of transition was altogether wrong since this has resulted in the overlooking of much more important factors of transition. It is other factors such as the initial condition in the country in terms of industry structure and trade patterns and the strength of state institutions during the transition period, rather than speed, that play a far more significant role for the outcome of the transition. (Popov, 2000)

3.1.3 RUSSIA- TRANSIT TRADE AND GEOPOLITICAL ISSUES

The collapse of the Soviet Union altered, among a great deal of other things, the geopolitical atmosphere in the Baltic Sea region. The long established transport pattern of (foreign) trade within the Soviet Union changed abruptly, since what used to be borders between national republics became national borders, and formerly domestic suppliers could suddenly turn into foreign trade partners (Brodin, 2000). The Baltic States regained independency resulted in a

far-reaching foreign trade reorientation towards the West. Furthermore, the loss of the Baltic States resulted in the loss of direct access to most of the Baltic Sea coastline. As a consequence, Russia's possibilities for efficient outflow to the West became a sensitive issue in the Baltic Sea region.

The economic center of Russia has always been placed well west of the southern Ural Mountains. This part of the country has been the center of industrial production, agriculture as well as the origin of most of the Russian foreign trade. This is where volumes for import or export are generated, thereby creating a demand for port and transport capacity. The current shape of Russia, gives the country access to open sea in all four geographical directions. In the north, Russia has only two major international ports, Murmansk and Arkhangelsk, but practically only Murmansk can handle regular all-year traffic. Of the ports located in the Far East along the Pacific coastline, only three of the most southern, Vladivostok, Vostochny and Nakhodka can be considered to be operating efficiently. Along the southern coastline, in the Black Sea, only Novorossiysk and the port in Taupse remained under Russian control. Finally, the ports in the Gulf of Finland that remained Russian are the ports in St Petersburg, Vyborg and Vysotsk. (Brodin, 2000)

Evaluating the different possible Russian transport corridors to the West, there are three possible domestic alternatives. These direct links from a Russian port to the markets in the West are; the ports in the Gulf of Finland, the ports in the Barents Sea or the ports in the Black Sea. The ports in the Far East are not considered since they are located nearly two weeks away from Moscow by regular freight train which hardly makes them attractive for foreign trade to the west. The advantage of the domestic ports is that they completely avoid the involvement of a third country for transshipment. However, the reality is that none of the domestic ports are really advantageous for large volumes of foreign trade. The most favorable route to the west is through the ports in the Gulf of Finland, however these ports are restrained by their capacity. Their main problems are either with shallow waters or severe ice-problems during the winters or both. The second best options are the ports in the Barents Sea, Murmansk and Arkhangelsk. These northern ports are the only domestic alternative with the existing capacity and the potential of being used for the

transport of goods to and from Russia. Nevertheless, the ports are mainly used for locally generated transport needs. The third option is however not considered an efficient solution since it results in not only longer transport distances on land and at sea, but also the troublesome passage of the Turkish Bosporos Strait into the Mediterranean. (Brodin, 2000)

Due to the problems and limitations of other options, most of Russia's exports and imports are today transited through the countries on the western borders, and will most probably continue to be transited[1] this way. From a Russian point of view there are at least five alternative transiting routes from Russia to the markets in the West. Although, in the Baltic Sea region it is only the Baltic countries, Finland, and possibly Poland that have a geographical location making it realistic to compete for the handling of west bound Russian transit cargoes. Today, the Baltic States are the most frequently used passage for transit trade to the western markets. (Brodin, 2000)

The three Baltic States have a number of ports, which are well oversized in comparison with their own needs. During the Soviet period they constituted important hubs for Soviet foreign trade and as such was constructed to handle large transport volumes. After the Baltic States regained their independence, they all strived to steer their economies away from the former dependence on Russia and have been successful in integrating their trade with their Nordic neighbors and other EU countries. However, the governments in the Baltic countries soon understood the importance of the transit trade to the whole economies of their small countries. Thus, it didn't take long before the relations even on the political front started to settle down. During the last few years, there has been a competition between the ports for the handling of the transit goods and there have been a number of shifts from the Russian side as who to comply with. (Brodin, 2000)

The geopolitical importance of the ports in the Baltics is evident when considering the fact that 70-95% of their load is transit trade to or from Russia.

[1] Transit should here be understood as the transport of cargoes passing the port area en route to a customer in the hinterland of the port, or to a ship in the port (Brodin, p 21)

The most important ports of these ports are Tallinn, Riga, Ventspils, Liepaja and Klaipeda. These ports have advantages such as being more or less ice-free during winter and some have a natural depth of several meters more than that which can be offered by competing Russian ports. The Baltic ports keep expanding, and the capacity of the new terminals will, to a tremendous extent, exceed local needs. Therefore, the investments are based on expected continued and dramatically expanding transit trade from Russia within the fort coming years. (Brodin, 2000)

Nevertheless, the Russian dependence on these ports for foreign trade is still a source of irritation, which has at times infected the relations between Russia and the Baltic States. The transit trade has been questioned in Russia because it is considered as a weak point, an "Achilles heal", and is therefore a source of geopolitical battlement. Besides the fact that the transit trade put the control and handling of Russia's goods in foreign hands, there are also additional costs for using these transit routes, since national boarders must be crossed. There are for example different customs regulations, taxes and transit fees depending on the kind of products that are transported. Since Russia has been struggling with their economy, the fulfillment of payments between new and unstable currencies has at times restricted the trade further. (Brodin, 2000)

In its present geographical form, Russia has a very limited number of possibilities as to where it could direct its sea-borne foreign trade, since it has proved nearly impossible to increase the efficiency of domestic ports. The chosen solution to this problem, that is said to be of national importance, is to undertake the building of new and expensive domestic ports that could handle Russia's foreign trade (Brodin, 2000). According to Brodin (2000), a better solution would be if the Baltic ports could reach a level of productivity similar to standards in European ports, so that it would seem foolish for Russia to redirect the flow of goods. The Baltic States could also handle the political tension of the transit trade by offering Russia stakes in port companies during privatization. Such an action would first of all give Russia back, at least partly, the feeling of control over its transport channels and might thus result in a friendlier relationship with Russia. Secondly, the flow of goods through the

Baltic ports would be secured and hence continue to generate economic well-being in the Baltic States (Brodin, 2000).

3.2 INTERNATIONALIZATION THEORY

It is obvious that companies choose to invest abroad because they consider such investment profitable. The theoretical question is thus why foreign investments seem profitable enough to motivate a company to enter a foreign and unknown market since there are undoubtedly costs and risks associated with such activities. (Hörnell & Vahlne, 1986) The theories on internationalization tend to deal with the investment decisions from different angles. However, they are all somewhat interconnected and together they comprise the basic understanding of the reasons behind foreign investments. In order to include some of the mainstream theories, the intention is to present the conventional hypothesis set out by Stephen Hymer, John Dunning, Raymond Vernon and the Uppsala behavioral school.

The pioneering work by Hymer in the 1960's constitute the basis for the modern understanding of the reasons behind foreign direct investment. Hymer's assumption was that domestic firms would undoubtedly have an advantage over foreign firms, in serving a particular market. The reason for this is that the domestic firms would have an inherent understanding of the local market, the business customs and the institutions of the environment such as the political or the legal framework. Consequently, a foreign company wishing to produce in that market has to have and be able to utilize advantages not possessed by its local competitors, in order to compete in that market. These advantages may derive from firm size and economies of scale, market power and marketing skills or superior technological know-how. (Dicken, 1998) Accordingly, this theory emanates from the assumption that the targeted aim of the investment is the opportunities of the market itself.

Quite independently of Hymer, Raymond Vernon introduced an explanation of the evolution process of international production in 1966. (Dicken, 1998) Vernon's major contribution was to extend the product cycle concept with a locational (position) dimension. Vernon starts out from the assumption that

producers are more likely to introduce new products in their home market, because of their market knowledge, than elsewhere. In the first phase of the product cycle, all production was located in the home market (Vernon's home market was the United States, since the theory emanated from studying firms in the United States) and overseas demand was served by exports. However, as the product began to reach its mature state, the United States firms set up production facilities in the overseas market either because they saw a possibility to reduce production or distribution costs, or in order to prevent local competition to threaten their market position (phase II). At first, the targeted overseas market tended to be Western Europe or Canada, since these markets also were high-income markets with the same standards of living and therefore also demand for same type of products. Eventually, the production cost advantages of the newer overseas facilities could initiate exports to other, third-country markets (phase III) and even back to the US (phase IV). Finally, as the product becomes completely standardized, production would be relocated to low-cost locations in developing countries (phase V). (Dicken, 1998) The contribution to the internationalization theory is that products and production derive from the home market and outwards.

In the 1970's John Dunning proposed a framework, an eclectic paradigm, which attempted to integrate the previous explanations of international production. Dunning suggested that a firm would commit in international production when the following three conditions are met. Firstly, a firm must possess firm-specific advantages not owned by its local competitors. This is the condition for the overseas production to be profitable at all. This condition correlates with Hymer's theory. Secondly, the firm itself must utilize such advantages internally rather than selling or leasing them to other firms. This implies that the company would like to protect its advantages and therefore resists depending on local agents or licenses. Usually, such advantages are derived from knowledge in innovation and technology. Thirdly, there must be location-specific advantages, which make it more profitable to exploit the firms' assets overseas rather than within the home market. Thus, in the absence of more favorable location conditions overseas, a firm would serve the foreign markets by exports from a domestic base. (Dicken, 1998) Dunning's condition two and three are to some extent linked with phase II and III in Vernon's

locational dimension on the product life cycle. However, the contribution of Dunning's eclectic theory is as mentioned the holistic picture that it provides.

Another hypothesis that tries to explain foreign direct investments is the behavioral approach developed by economists from Uppsala University. In the behavioral approach the internationalization of a company is seen as a step-by-step process, gradually increasing the company's international involvement. The first step is to export the companies' products by the means of an agent to the foreign market. The next is to establish relations with a local supplier through which the products are offered. Thirdly, a subsidiary is established in the local market. and the fourth and final step is to initiate local production and directly supplying the local market. The purpose of this step-wise process is to minimize the risks associated with foreign investments through investing limited resources at first, and meanwhile acquiring knowledge about the foreign market and its potential through experience of business activities in the first steps. Thereafter, if the conditions are right, the commitment of resources increases and a production facility might be built. (Golubeva, 2001) As a result, firms are expected to enter new markets with successively greater physical distance, meaning that investment goes first to culturally close countries. The physic distance between the home country and the foreign country is recognized in terms of difference in language, culture and historical traditions between the two countries. (Hörnell & Vahlne, 1986) However, this theory is built upon the assumption that the aim is to gain market access (market-seeking investment) rather than production benefits (Hood & Young, 2000).

3.2.1 FDI IN TRANSITION COUNTRIES

Evidently, the risks associated with foreign direct investments are even higher when investing into a transition country. A transition country is a non-planned, non-market economy and the new emerging market institutions parallel with bureaucracy and hierarchy inherited from the old administrative system could influence foreign direct investment (FDI) decision-making. Among these transition related factors are political instability, unpredictability of the development, and frequently changing legislation. (Golubeva, 2001) Still there are many foreign companies that put in resources and commitment into

transition countries, although the explanations might differ. Here, foreign direct investments in transition countries are discussed more thoroughly, as a consequence of the specific characteristics of a transition country.

The low labor cost hypothesis is often suggested as an explanation for foreign investments into transition countries. The argument is that low labor cost inputs, especially labor force with a level of skills comparable with what is found in industrialized countries, may increase a firm's value and hence act as an important incentive to expand internationally. A related hypothesis is that of benefits of national resources and local production costs, which imply that inexpensive local production costs and sources of raw materials motivate FDI in transition economies. Both of these explanations emanates from the belief that the prospect of cutting production costs is enough motivation for a company to invest in a transition country. (Golubeva, 2001) Considerable research has been carried out about the connection between resource oriented motives and FDI, and there are contradicting opinions on this matter. According to Lankes and Venables (Golubeva) there are many case studies supporting this hypothesis. On the other hand, Meyer (Golubeva), concludes that no supporting evidence exist that the search for low labor costs has been a major motive for firms investing in Central and Eastern Europe. In a survey conducted by the consultant Arthur Andersen (1994) on the assignment of the Organization for Economic Co-operation and Development (OECD) only nine percent of the inquired mentioned the outlook of cutting production costs as a motive for investment. Therefore, cheap resources and low labor costs, even though considered in the investment process, was classified as a short-term benefit rather than a key motive factor. (OECD, 1994)

According to the Arthur Andersen survey (OECD, 1994) investors are unanimous in seeing the market size, opportunity and long-term growth potential of the Central and Eastern European Countries (CEEC) and the Newly Independent States (NIS) as the prime attraction for investments into these markets. These markets are perceived as one of the few untapped markets of the world. Therefore, the investments are grounded on a long-term strategic view of the possibilities in these countries and despite the perceived risks the investors are positioning themselves to take advantage of the expected

opportunities. (OECD, 1994) This result is supported by an extensive number of other researchers, Burger and Jungnickel, Meyer, Lavigne and Stankovsky (Golubeva, 2001).

Another important determinant of investment into a transition country is the "closeness" to the country, in terms of location, culture or history. Neal (1997) suggests that the culture factor poses the greatest threat to companies operating in unstable and uncertain markets. The decision to invest in transition markets, must therefore take the influence of culture into account in the early phase of FDI decision-making. (Golubeva, 2001) Another factor affecting the origin of investments into transition countries is geographical proximity. Meyer (Golubeva, 2001) has for example been able to show that German companies have been more active in Central and East European countries than British firms due to their proximity to the region. In addition, related histories have also proved to have an impact on investment decisions into transition countries since it creates a feeling of connection with the country.

3.3 THEORY OF INTERNATIONAL TRADE

In this section, the basic ideas with the main trade theories will be shortly presented. These include mercantilism that prevailed as early as during the seventeenth and eighteenth centuries, the theory of absolute advantage, the theory of comparative advantage and the Heckscher-Ohlin theory. However, to complement these traditional trade theories this chapter will end with a short explanation of more modern theories of trade.

3.3.1 THE MERCANTILIST'S VIEWS ON TRADE

The earliest writings of international trade originate from a group of men in countries like England, Spain, France, Portugal and the Netherlands during the seventeenth and eighteenth centuries. Their essays on international trade later become famous under an economic philosophy known as mercantilism. The mercantilists argued that the means for a country to become wealthy and powerful was to export more than it imported. As a result, a country's government had to maximize the exports and minimize imports. The export

surplus would then be measured in gold and silver, since the mercantilists measured the wealth of a country by the stock of precious metals. Thus, the more gold and silver a nation had, the wealthier and more influential it was. However, all nations could obviously not have an export surplus at the same time resulting in the belief that one nation only could gain at the expense of other nations. Consequently, the mercantilists promoted strict economic government control and favored economic nationalism, ideas that later would be opposed by classical economists like Adam Smith and David Ricardo. (Salvatore, 1995)

3.3.2 ABSOLUTE ADVANTAGE

Adam Smith concluded that two nations would only trade with each other if both would gain from the trade. Opposed to the mercantilists, Adam Smith argued that the trade between two nations is based on absolute advantage. When one nation has an absolute advantage (or is more efficient than the other) in manufacturing a specific good, but simultaneously has an absolute disadvantage in producing another good, both nations have the opportunity to gain if they specialize their manufacturing of the good that they have an absolute advantage. Consequently, each nation will produce more than needed domestically of goods that it has an absolute advantage of in order to exchange this surplus against goods that it has an absolute disadvantage in producing. As a result, resources are utilized, the output of both goods will increase and the welfare of all individuals is maximized. According to Smith, absolute advantages could for instance occur due to differing climate conditions between two countries. (Salvatore, 1995)

Hence, opposed to the mercantilists view on trade, where one nation can only win at the expense of another and where the government controls all economic activities and trade, the classical economists (with Adam Smith as its precursor) believed that all nations would gain from free trade and promoted as little government interference as possible (laissez-faire). However, today only a small share of world trade could be explained by absolute advantage. Thus, still explanations of international trade remained and those would come with the law of comparative advantage, developed by David Ricardo. (Salvatore, 1995)

3.3.3 THE LAW OF COMPARATIVE ADVANTAGE

The law of comparative advantage was already known in 1817 when it was first published. It has proved to be one of the most significant laws of economies and is still highly relevant as a theory today. According to the law of comparative advantage, even though one nation has an absolute disadvantage in the production of both goods in the example mentioned above, there is still a possibility for equally beneficial trade. One of the nations could specialize in the production of the goods in which it has a comparative advantage (the least absolute disadvantage) and import the other good, where its absolute disadvantage is larger. Accordingly, both nations have the possibility to gain from trade even though one of them is less efficient in manufacturing both goods. (Salvatore, 1995)

However, there is a small possibility that the absolute disadvantage that one nation has with another equally concerns both goods. Thus, taking this exception in account, the law of comparative advantage reads as follows: "*Even if one nation has an absolute disadvantage with respect to the other nation in the production of both commodities, there is still a basis for mutually beneficial trade,* ***unless the absolute disadvantage is in the same proportion for the two commodities***" (Salvatore, 1995, p. 33-34). Yet, although this should be mentioned it is important to note that this exception is extremely uncommon.

3.3.4 THE HECKSHER-OHLIN THEORY

According to classical economists, the comparative advantage was based on the difference in the productivity of labor among nations. However, the only explanation given by the classical economists to this existing difference in productivity was differences in climate. Hence, the Heckscher-Ohlin theory basically includes the explanation of two theories: one that deals with the prediction of the pattern of the trade (the so called H-O theory) and one dealing with the effect of international trade on factor prices (the factor-price equalization theory). The Heckscher-Ohlin theory is based on a number of assumptions, e.g. two nations, two commodities, two factors of production, the same technology is used in both nations, there are no transport costs or tariffs

and the taste and so on, that simplifies the preconditions of the theory and facilitates the drawing of conclusions. (Salvatore, 1995)

The H-O theory states: "*A nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor*" (Salvatore, 1995, p. 118-119). Thus, the labor-rich nation supposedly exports the labor-intensive commodity and imports the capital-intensive commodity and the other way around.

The factor-price equalization theory states: " *International trade will bring about equalization in the relative and absolute returns to homogenous factors across nations*" (Salvatore, 1995, p. 125). Accordingly, international trade will reduce the preconditioned differences between two countries and result in equal wages for labor with the same level of training, skills and productivity in all trading nations. The same will be true for the return on capital with the same productivity and risk. (Salvatore, 1995)

Consequently, Heckscher and Ohlin argue that the difference in factor endowments offers the basic explanation to the comparative advantage of a nation. International trade can also be seen as an alternative to the international mobility of factors to even out the profits of homogenous factors across nations. This is due to the fact that all factor and commodity markets are part of an overall unified system, which means that one adjustment or change in one part of this system will affect all the other parts. (Salvatore, 1995)

3.3.5 MODERN THEORIES OF TRADE

The previously presented theories explain how differences in national resources, technology and tastes result in the specialization of certain products in different countries and in mutual trade between countries. This would assume that international trade largely consists of countries with most differing resources and technology and that the goods exported and imported would be of a highly specialized character, one country would for example export bananas and import TV sets. However, it is obvious that today's modern trade

does not coincide with this pattern. In fact, the proportion of world trade that takes place between similar countries (that is, developed countries) is far larger than the share of trade between developed and developing nations. Hence, there have been a number of attempts to explain other reasons for international trade than the traditional ones. These include economies of scale and imperfect competition. Applying the explanation of economies of scale, countries do not have to differ to trade with one another. Due to the existence of economies of scale, two identical countries may still produce different goods and enjoy mutually beneficial trade. Thus, other reasons than comparative advantage could explain the motives for two identical countries to trade such as historical or accidental factors (for example the "first mover advantage"). (Mikic, 1998)

Additionally, since all the traditional theories of trade are based on perfect competition and since the real world hardly is comparable to this assumption, attempts have been made to explain trade under imperfect competition (such as oligopoly and monopolistic competition). (Mikic, 1998) Imperfect competition arises from the fact that consumers generally demand differentiated products. Differentiated products are products that slightly differ from one another such as various brands of cars, soft drinks and health care products. As a result, a great deal of international trade includes trade within the same industry (intra-industry trade), since one country generally specializes in producing one or two brands and import a variety of brands to complement the consumer's possibilities to choose. Thus, intra-industry trade is a consequence of international competition which forces companies to specialize on one or two product varieties and thereby take advantage of economies of scale in their production. Additionally, economies of scale have also contributed to the increase of international trade of parts and components. International companies try to minimize their costs by producing components in countries where it is most cost-efficient. To conclude, the larger difference in factor endowments between two countries (as between developed and developing countries), the more essential is the law of comparative advantage and inter-industry trade. In contrast, the greater similarity between two countries, the more common intra-industry trade seems to be. (Salvatore, 1995)

3.4 TRANSPORT-ECONOMICAL THEORY

This thesis treats the foreign trade development of the Baltic states. Accordingly, the focus in this chapter is on international transportation and on parts of transportation theory that are relevant for foreign trade. The aim is to gain a brief, general understanding of the reasons for the transportation of goods and the dependency on transportation in today's international trade.

3.4.1 TRANSPORTATION DEFINED

Transportation is only one of the constituents of logistics, the others being the integration of information, inventory, warehousing, material handling and packaging. Transportation is obviously one of the most observable parts of the logistics procedure due to the many trucks and trains that are used for the transportation of goods in today's society. (Bowersox and Closs, 1996)

The main task of transportation is to move people and goods from one place to another. Coyle, Bardi and Novack (1994) define transportation as "the creation of place and time utility", where place utility means that goods are moved to a place where they have higher value than they had at the original place. Further, place utility is created when transportation costs are reduced, which encourages producers to purchase products or raw material from more distant suppliers. Time utility means that the service of transportation takes place when it is needed and refers to the fact that the demand for certain goods only exists during limited periods of time. Examples of such products are those related to national holidays. Christmas trees, Halloween costumes or Easter bunnies are only sold during certain periods of the year. Hence, time utility is created by efficient transportation that makes sure that those products will be available at the appropriate location for customers when needed. (Coyle, Bardi and Novack, 1994)

Transportation has two major functions: product movement and product storage. Irrespective of the kind of product produced, some kind of transportation will always be required to move the product to the next production stage or closer to the final customer. Transportation uses resources

such as environmental resources, which are the usage of fuel and oil and the creation of congestion, air pollution and noise pollution, and financial resources, which include the expenses for the driver labor and for operating the vehicle. As a result, it is essential that goods be moved only when it is absolutely certain that the value of the product will improve. Accordingly, the major aim of transportation is to move goods between two locations while minimizing costs although simultaneously meeting the demands of customers concerning delivery performance and shipment information availability. The temporal storage of products on vehicles during transportation is quite an expensive kind of storage. However, products are frequently moved again and generally do not remain stored in vehicles for longer periods of time. Therefore, the cost of unloading and reloading the products in warehouses is often higher than the storage in the transportation vehicle. (Bowersox and Closs, 1996)

Three main factors are fundamental for the transportation performance: cost, speed and consistency. The cost of transport refers to expenses for moving a good from one geographical location to another. The speed is obviously how quickly something is moved. It is essential to find the correct balance between cost and speed since the faster a service is provided, the higher are the costs. In turn, the higher the speed, the shorter the transporting time for the good and thus, the shorter the time when the good is unavailable for the customer. Finally, consistency when it comes to the speed of the performed transportation is vital. Thus, if a shipment takes two days one time and five days the next, the problem of inconsistency is clearly affecting both the buyer and the seller. Time is valuable in logistics and speed and consistency together create quality in transportation. (Bowersox and Closs, 1996)

There are five major ways of transporting goods. These include motor carriers (trucks), railroads, airline carriers, water carriers and pipelines. The motor carrier industry is known for its generally higher quality of service especially regarding accessibility, speed, reliability, frequency and lower loss and damage rates and therefore plays a major role in the transportation of higher valued and time-sensitive traffic. Railroads were historically essential in the transportation of a wide range of commodities. However, nowadays railroads focus on moving low value, high-density bulk products. The main advantage of airline

carriers is speed although the costs are higher. Accordingly, airlines often take smaller shipments with high value and fragile products. Water is the oldest mode of transportation. Water carriers major advantage is the capacity of moving extremely large shipments. The main disadvantages are speed and operation although the cost is relatively low. Finally, pipelines represent a unique transportation system in itself, operating 24 hours a day, seven days a week. Once a pipeline has been constructed the operating cost is extremely low since pipelines are not labor-intensive. However, pipelines are not flexible and unfortunately limited to oil and oil products, natural gas, chemicals and coal. (Bowersox and Closs, 1996, Coyle, Bardi and Novack, 1994)

3.4.2 INTERNATIONAL TRANSPORTATION

A specific area or country will specialize in the large-scale production of goods for which it has the greatest advantage compared to other countries. However, a country cannot rely upon its comparative advantage and large-scale production without an efficient transportation system that can transport the produced goods to other areas or countries that need them. (Coyle, Bardi and Novack, 1994)

Globalization has completely changed the prerequisites for today's businesses and has forced enterprises to alter their ways of doing business. There are many factors influencing a company to internationalize. Enterprises are to a larger extent forced to expand to grow and survive in today's fierce competition. Additionally, the further development of technologies and capabilities are facilitated by increased global operations. There are five main factors driving the increasing global operations of firms: economic growth, supply chain perspective, regionalization, technology and deregulation. These are discussed below. (Bowersox and Closs, 1996)

Economic growth. Firms' opportunities of further economic growth have been substantially diminished since the major industrial markets have stabilized or declined. Hence, the contemporary situation force enterprises to increase profits through global expansion into other developed or developing markets.

Supply Chain Perspectives. The business environment of today has also introduced the outsourcing of parts of the supply chain of logistical activities to lower costs. Further, the fierce competition force firms to increased economies of scale and efficiency and thus, to outsource large parts of their production to other countries. Accordingly, this has resulted in an even higher dependency on transportation. The choice of location for production or for the imports of raw material is to a large extent influenced by transportation factors. The outsourcing of production is only made possible due to the lower costs and efficiency of the modern transportation. Thus, transportation and logistics play an increasingly significant part of firms of today.

Regionalization. Enterprises' need to develop entirely new markets has resulted in a number of regional agreements or partnerships, with the purpose of facilitating trade, between nations all over the world, the North American Free Trade Agreement (NAFTA) and the European Union (EU) being two examples.

Technology. The development of communication and information technology has created a global need for products through the exposure of foreign consumers to foreign products. Greater information exchange between companies around the world as a result of the increased availability of computers and communication networks has also encouraged the internationalization.

Deregulation. Deregulation of the financing and the transportation sectors has further motivated global expansion. Changes in regulations and procedures as well as the free flow of currency exchange have facilitated global business. Relaxed regulations and restrictions and increased privatization in the transportation sector has improved flexibility and efficiency and has consequently facilitated the internationalization of enterprises. (Bowersox and Closs, 1996)

As a result, transportation has proved to be even more significant with today's globalization than ever before. Companies depend on efficient transportation systems to better utilize the opportunities of internationalization. Without the

possibility of moving goods at low cost, high speed and consistency in speed, globalization would have been impossible. Irrespectively of the goods produced and where, some kind of transportation is and will always be necessary for the movement of goods.

3.5 CHAPTHER SUMMARY

The purpose of this chapter was to highlight different views of the existing theory that are somehow connected to the main research focus of this thesis. Due to the nature of the problem, the environment in which it is studied and the attempt to predict the future, a traditional use of theory has not been considered applicable to this study. Moreover, the various theory components serve as a background to gain a broader comprehension of the specific circumstances under which this study is executed.

First of all, transition theory is considered crucial to be able to comprehend the special preconditions of foreign trade in the Baltic countries. Transition theory provides this thesis with the core understanding of the circumstances under which foreign trade is developed in the Baltic countries. The reader must fully comprehend the preconditions of a transition economy and the varying paths of progress undertaken in different transition economies, to understand the analysis and conclusions in this study.

The transition theory is concluded with a discussion of the geopolitical relations with Russia. Transit trade is an economically very important factor for the Baltic States, but however also a very delicate issue which must be handled with consideration also from the Russian perspective in order to preserve the transit trade through the Baltic countries also for the future.

Internationalization theory explains the basic reasons for foreign direct investments. As will later be more thoroughly discussed in the analysis chapter, the extent of foreign direct investments greatly contribute to the foreign trade development in transition countries.

The presentation of basic trade theories aims to clarify the motives for trade across international borders. At the beginning of its development countries like the Estonia, Latvia and Lithuania have taken advantage of their overall strength in low production costs. Hence, so far, the Baltic region has been able to gain from international trade based on economies of scale and the urge of international companies to minimize costs. Gradually though, other factors will become increasingly important to further utilize foreign trade. However, since the main problem does not aim to investigate foreign trade as such, but rather the prediction of foreign trade primary in terms of trading partners, these theories will not be used in the analysis.

Finally, the great reduction of transportation costs has naturally facilitated international trade. Thus, transport-economical issues enable international trade to function and it is crucial for the Baltic area to develop efficient means of transporting goods to facilitate its development of exports. In this context, the Baltic ports also play a vital part.

4. COMPARISON OF THE BALTIC COUNTRIES' TRANSITION

Since they regained independence, all the Baltic countries have gone through extensive and radical changes on their way towards a market economy. As all three countries faced extremely bad economic situations immediately after regaining independence, macroeconomic stabilization, as in other transition countries, become first priority. The Baltic States apparently had fairly similar starting points entering transition, but due to different choices of management and directions, the development has been quite different between the three countries. This chapter serves as a background to enhance the general understanding of the Baltic region of today. Further, the purpose of this chapter is to make a comparison between the three countries in their development.

4.1 ESTONIA

REPUBLIC OF ESTONIA

Population: 1,431,471 (July 2000 est)[1]
Land area: 43,211 sq km[1]
Government type: parliamentary democracy[1]
GDP- real growth rate: 6,9% (2000)[2]
Inflation rate (consumer prices): 5,0% (2000)[2]
Unemployment rate: 13,9% (2000)[2]
Currency: Estonian kroon (EKK)[1]

Source: 1) www.cia.gov, 2) www.bof.fi

4.1.1 ROUTE OF TRANSITION

Estonia was the last country of the Baltic States to regain independence, in August, 1991. Out of the Baltic countries, Estonia has been the pioneer in introducing most of the stabilization and structural reforms. Its rapid and extensive development of reforms has often been referred to as a shock

treatment and has proved to be very successful. One of the most important success factors of all the Baltic States' development during the 1990's was their early introduction of national currencies. Estonia became the initiator in introducing its own currency in June 1992. The Estonian Kroon was pegged to the German mark, which since 1999 means that it is indirectly pegged to the Euro as well. (Norgaard, 1996) The fixed exchange rate regime resulted in increasing production costs due to continuous appreciation of the price of domestic production, but has on the other hand also maintained the competitiveness of Estonian companies and there has been a rapid growth of output and exports. (www.bof.fi)

As a consequence of the relatively limited choices in the economic policy due to the fixed currency board, goods, services, money and capital were all liberalized from the beginning. The reasons for an open and liberal economy were the small domestic market, the economic decline at that time as well as the low purchasing power of the small population, which together forced Estonian companies to export a great part of their total production. Accordingly, Estonia simultaneously began its price liberalization and foreign trade liberalization in 1991. By 1993 nearly all goods were exported and imported without tariffs. Due to the early price reform and strict fiscal policies and tax reforms, Estonia was able to avoid budget deficits and was also most successful in controlling the high inflation. (Norgaard, 1996) Inflation has stayed on a relatively modest level, but started to increase during 2000 due to higher oil and energy prices and weakening of the kroon and has continued to do so also during the first part of this year. Unemployment has risen steadily since the beginning of 1998, reaching 13,9% in 2000. (www.bof.fi)

Estonia proved to be most successful of the Baltic countries also in privatization where the government chose to use the experienced German Treuhandanstalt privatization agency, responsible for privatizing companies in Eastern Germany. Thus, all the companies in Estonia were sold through one central organ, the Estonian Privatization Agency (EPA) using open tender offers and direct sales to strategic investors as the main methods. The EPA chose to sell the state-owned companies without restructuring. Companies were sold to a great extent to producer owners and accordingly not to banks,

investment companies or employers and foreign investors were often favored in the negotiations. Privatization in Estonia has certainly benefited from its openness to foreigners since the restructuring of enterprises is enhanced by foreign management. A voucher program was also used from the beginning, distributing vouchers to the whole population, the number of vouchers depending on the number of years people have worked for the Estonian state. (Norgaard, 1996, Nordregio Report, 2000) Through this rapid and effective program, privatization was almost completed as early as 1997 and the whole financial sector is today privately owned, with a large share of foreign ownership. The privatization has reached the final step, which includes privatization of infrastructure including Estonian railway and the Narva Power Stations, Estonia's energy complex. Additionally, there have been discussions to partly privatize the Port of Tallinn. Accordingly, only a few large enterprises and public utilities are still owned by the state in Estonia today. (www.bof.fi)

Since 1995, economic growth has been apparent in Estonia. 1997 was a record year with growth reaching an impressive rate of 10,6%. Even though Estonia does not have as tight trade links and financial exposure to Russia as its neighbors, the economy was still affected by the Russian crisis. (www.worldtrade.org) Russia was actually one of its three largest trading partners and more important than statistics might have shown. Due to higher customs duties on Estonian goods after independence, Estonia exported (and still export) a severe amount of goods through other countries to reach Russia, Finland being one of the most important. This is evidently not apparent in the official statistics. (www.bof.fi) Most of the affect of the Russian crisis was felt in 1999 when foreign trade volumes fell sharply and real GDP decreased by 1,4%. (www.worldtrade.org) However, Estonia recovered quite fast and growth for 2000 was 6,9%. Although growth slowed down somewhat during the first half of 2001, experts were still confident that growth would continue and predicted a growth of 5 to 6% for this year (2001). (www.stat.ee) Still, due to the recent tragedy in the USA and the following recession in the world economy, growth is predicted to decrease further and end up between 4 and 5% instead. (www.bof.fi)

4.1.2 FDI & FOREIGN TRADE

In such a small country as Estonia, where natural resources are scarce and the domestic demand consist of only 1,4 million people, economic growth is largely dependant upon external demand. Accordingly, trade is seen as the key to economic growth. Therefore, Estonia has done its best to take advantage of and develop its foreign trade as well as to attract foreign investors to the country. A great deal of the reforms and actions has been with the aim of attracting foreign direct investment to the country. In fact, Estonia was the first country in the Baltic region to open up its market to foreign investors and has also been the most successful in doing so. It is not a coincidence that the currency is tied to the German mark or that quite early on Estonia became an advocate of free trade or that there are no export tariffs. Since October 1999, Estonia is also a member of the world trade organization (WTO) (www.bof.fi).

Since transition started, Estonia has gone through a massive reorientation of its foreign trade from the East to the West. Trade with the West has increased substantially, especially with the Nordic countries, and today over 70% of Estonian exports go to EU countries. Finland and Sweden are by far the most significant trading partners in exports as well as imports. Concerning commodity groups, machinery and equipment is the most important source of both exports and imports, followed by wood articles and textile. Estonia became successful in attracting foreign high-tech assembly industries and an important subcontractor for western companies. Today, subcontracting still make up a substantial part of the industry, up to 75-85% in machinery and equipment, electronics and textile. (www.investinestonia.com)

4.2 LATVIA

REPUBLIC OF LATVIA

Population: 2,385,231 (July 2001 est)[1]
Land area: 64,589 sq km[1]
Government type: parliamentary democracy[1]
GDP- real growth rate: 6,6% (2000)[2]
Inflation rate (consumer prices): 2,7% (2000)[2]
Unemployment rate: 14,4% (2000)[2]
Currency: Latvian lat (LVL)[1]

Source: 1) www.cia.gov, 2) www.bof.fi

4.2.1 ROUTE OF TRANSITION

Latvia regained independence in May 1990. The country's path towards a free market economy puts it in between Estonia and Lithuania with regard to speed and implementation of reforms. Due to a quick introduction of price and trade liberalization together with privatization, Latvia's transition is more equivalent to a "big bang" than a gradualist approach. Still, because of the slow progress in some of the reforms, mainly privatization, Latvia cannot be considered as radical as Estonia.

However, the transition has not been easy. Latvia introduced an extensive macroeconomic stabilization program in 1992 supported by the introduction of its own currency, the Lat, in 1993. (www.worldbank.org) In contrast to its neighbors, the Latvian government chose a traditional central bank policy based on the German model. The national Lat was eventually introduced in October 1993 (and is today pegged to the exchange rate basket SDR). (Norgaard, 1996) As in all transition countries, the introduction of stabilization and market reforms created a sharp fall in GDP, production and in real wages at the beginning.

However, economic growth was further disturbed by serious banking and financial crises in 1995 resulting in an extended GDP fall. Due to tight

monetary and financial policies and the establishment of an improved legal framework for the banking sector, growth was eventually restored in 1997. (www.bof.fi) Yet, the economic crisis of Russia in 1998 severely damaged the Latvian economy although it did not result in negative growth rates as in Estonia and Lithuania. The reasons for the relatively quick stabilization were that the private consumption was still quite high and that the transit trade with Russia was reestablished thanks to increased oil prices and demand from the West. (www.seb.se) During 2000, Latvia recovered and growth was restored. Latvia has experienced an incredible economic growth during the last two years. (6,6% for 2000) In the first quarter of 2001, Latvia reached an impressive rate of 8,2% (!) GDP growth although experts estimate the growth to slow down this year, ending at 5,4% for the whole 2001. It is not clear how much the current world recession will affect this number since the Latvian exports are highly sensitive towards changes in the business cycle. The recent growth was mainly a result of an increase in the service sector, especially in trade and transport services. Amazingly enough though, a great part of the growth can also be explained by an increasing domestic demand although export growth also has been optimistic. (www.bof.fi, www.csb.lv)

Unemployment has remained on quite high levels (around 14%) and is estimated to continue to do so for this year. Latvia has further managed to keep the inflation rate at extremely low levels during the last few years (reaching only 1,8% in 2000). During the first part of the transition period, Latvia had one of the lowest current account deficits among transition countries. However, from 1998 Latvia's current account deficit started to grow although it has decreased somewhat during the last two years. (www.bof.fi, www.csb.lv)

When it comes to structural reforms, Latvia has made impressive progress in various areas. However, certain structural reforms, especially privatization, were delayed due to the lengthy government formation process. Price liberalization, opening up to foreign trade and privatization were all initiated simultaneously with the stabilizations program already in 1992. Foreign trade liberalization was affected by powerful lobbying which resulted in a number of import tariffs on agricultural products. (www.worldbank.org, Norgaard, 1996) As agriculture was badly damaged by the Russian crisis, (Russia being the

major export destination of food), the Latvian government responded by imposing import tariffs. These have been a subject of major discussion and contradiction since the tariffs affect the Estonian and Lithuanian exports to Latvia. The EU has also objected to these tariffs since they are against the EU law. (www.bof.fi)

Initially, privatization was lagging behind the other reforms due to a chaotic and non-functioning legal framework. Before 1994, companies were privatized using the voucher system (distribution of shares to employees) as well as restitution and sales to private investors. A large number of companies (75-90%) were sold to private investors who had either no interest in taking part of the production development or who did not have the capital needed for major investments. As a result, a wide range of different owners with diversified interests and lack of know-how and capital led to many difficulties in management and investment. Furthermore, the banks and investment funds were practically excluded from the privatization. However, in 1994 the privatization system was radically changed due to the establishment of the Latvian Privatization Agency and a similar system to that was initiated in Estonia was adopted. As a result, practically the same methods of open tenders and direct sale to strategic investors as in Estonia has been used. Although the large-scale privatization did not begin until the middle of the 1990s, the process has been fast and successful. Yet, the privatization of state-owned industry has been extremely slow and there still remain many state-owned companies. (Nordregio Report, 2000, Norgaard, 1996) Additionally, the Latvian Privatization Agency (LPA) has been heavily criticized and privatization has continued to be an issue of concern and disagreements between powerful industry groups. This has undoubtedly contributed to the slow progress. (www.bof.fi)

4.2.2 FDI & FOREIGN TRADE

Latvia has not been as successful in attracting foreign investors to the country as Estonia although the number of foreign investments has increased substantially during the last few years. The largest investors in Latvia are Denmark, USA and Sweden. As Estonia, Latvia has reorganized its trade from

East to West, mainly due to the economic climate in Russia. Today, about 63% of the exports go to EU countries and Germany and UK are the most important destinations of export. The central export goods are wood and wood articles, textiles, food products and base metal products. (www.swedishtrade.se) The investment volume into Latvia will undoubtedly increase substantially if Finnish-Swedish Paper and Pulp group Metsäliitto-Södra plans to invest almost one billion USD with the intention of starting up a pulp factory will be realized. In this case, it would be the single largest investment made in the Baltic countries. Latvia was the first Baltic country to become accepted as a member of the WTO, in October 1998. (www.bof.fi)

4.3 LITHUANIA

REPUBLIC OF LITHUANIA

Population: 3,620,756 (July 2000 est)[1]
Land area: 65,200 sq km[1]
Government type: parliamentary democracy[1]
GDP- real growth rate: 3,3% (2000)[2]
Inflation rate (consumer prices): 1,4% (2000)[3]
Unemployment rate: 16,1% (2000)[2]
Currency: Lithuanian litas[1]

Source: 1) www.cia.gov, 2) www.bof.fi, 3) www.std.lt

4.3.1 ROUTE OF TRANSITION

Lithuania regained independence in March 1990. Developments in Lithuania have been very uneven and remarkably slow which has made the country lag behind its northern neighbors during the whole 1990's. This is, to a certain extent, even true today although Lithuania truly has made impressive progress during the last few years. Today, Lithuania operates with a very similar currency system to that of Estonia although the situation was very unstable from the beginning. In fact, political interference in monetary and fiscal policies held up the stabilization. Partly as a result of this, a new currency board was introduced in 1994. Since then, the Litas has been pegged to the US

dollar at a fixed rate. (Norgaard, 1996, www.swedishtrade.se) To enhance the cooperation with the EU and improve the situation for Lithuanian exporters, the Litas will be pegged to the Euro in 2002. (www.bof.fi)

All in all, Lithuania has been very successful in stabilizing its economy, in the liberalization of trade and prices and in building market institutions. However, the government of Lithuania chose a more gradual approach to transition and market reforms were therefore introduced more slowly than in Estonia and Latvia. Lithuania was the last country of the three to liberate its prices and its foreign trade. Nevertheless, Lithuania has so far also had some major problems and obstacles during its transition process. The country has experienced major difficulties in balancing the budget and decreasing the inflation rate. Already in 1993, Lithuania experienced a current account deficit, which continued to be a problem. (www.swedishtrade.se) Due to relatively low levels of foreign direct investments, the current account deficit was initially mainly financed by loans and accordingly not by FDI as has been the case in the other Baltic states. As a result, Lithuania has the highest state debt among the Baltic countries. (www.bof.fi)

Yet, an even more serious difficulty first became evident after the Russian crisis and concerns hidden fiscal liabilities especially to the energy, agriculture and banking sectors. These liabilities are of major concern since they can make Lithuania vulnerable to external shocks and to unexpected internal policy changes. (worldbank.org) In recent years however, inflation has remained at a very low level. Unemployment on the other hand, has been quite high, as in Estonia and Latvia, ending at an average 16,1% in 2000. (www.std.lt) Two other factors have further complicated the economic situation in Lithuania; high oil prices and the strong US dollar. Since the Lithuanian Litas is pegged to the US dollar, the country has had major problems to sell its products to the Western markets. (www.swedishtrade.se)

As with the liberalization of the economy, privatization has been delayed in Lithuania mainly due to the many confusing changes in the legal framework since the independence. In addition, Lithuania initially chose a completely different approach than the two other countries. Here, the privatization process

became first priority and a voucher-based mass privatization program was introduced in 1991 as an important constituent of the economic reforms from the beginning. This approach apparently favored enterprise insiders. Concerning the privatization of state-owned industry, Lithuania was very successful, although there was a lack of incentive for the restructuring of enterprises and a severe lack of foreign investments and management. The latter was a result of the initial attitude of the government to prevent foreign investors and thus, mainly favoring domestic companies without foreign capital. This scared away the foreign investors from Lithuania. Another major problem and cause of the slow privatization pace in Lithuania has been the privatization of agriculture. The country has traditionally been an agrigarian country depending on its agriculture. Here the privatization was characterized by political conflicts, which was a major factor in delaying the process. (Norgaard, 1996, Nordregio Report, 2000) Since 1997, the pace of medium- and large-scale privatization has increased due to a reorientation of privatization towards direct sales and tenders. Still, a large number of enterprises remain state-owned in Lithuania today. (www.bof.fi)

As in the other Baltic states, the reforms initially caused a steep fall in the production. However, Lithuania had the most serious decline of the Baltic countries in combination with a slower recovery. Growth was restored in 1995 and grew by an impressive rate of 7.3% in 1997. However, the Russian crisis affected the economic development to a large extent mainly due to Lithuania's trade links with former CIS countries but also in combination with late macroeconomic measures and a strong currency (due to the tight connection with the US dollar). The Russian crisis also resulted in a steep increase in the government deficit and further worsened the current account deficit. It seems as if the crisis certainly had a larger affect here than in Estonia and Latvia. Lithuania felt the outcome of the crisis later, but the recession was deeper. (www.worldbank.org) Yet, as a result of the damages to the Lithuanian economy, the government accelerated the speed of the economic restructuring and introduced further stabilization measures. After a relatively uneven GDP growth during 2000, recovery was first visible and real GDP increased to 4.1%, as a consequence of the rise of exports and thus, external demand. GDP growth is expected to continue to grow at a slower pace than in Estonia and Latvia,

experts forecasted a 3,6% growth for this year and 3,1% for 2002. However, the uncertainty is even greater after the recent events in the US. (www.bof.fi)

4.3.2 FDI & FOREIGN TRADE

Lithuania has been much more modest in liberalizing and attracting foreign investors. Lithuania's economy has in fact been prevented from growing to a certain extent by the quite low inflow of foreign direct investments and by the dominance of its agriculture sector. Lithuania has also had increasing difficulties to export its products due to the high dollar exchange rate. Accordingly, FDI has been quite slow to reach Lithuania although major progress has been made during the last few years. The situation changed completely with the privatization of the Lithuanian Telecom in 1998. Since then, the flow of FDI has increased immensely. (www.bof.fi) Sweden has been one of the most important direct investors lately, followed by the USA and Finland. Main obstacles in the attraction of foreign investments are the complicated legislation and the lack of domestic capital. The main part (around one third) of the investments has been in the engineering industry. (www.swedishtrade.se) Lithuania became a member of the WTO earlier this year (April, 2001) (www.bof.fi).

At the beginning, Lithuania's trade continued to be mainly eastern directed. The Russian crisis thus forced Lithuania to redirect its trade in a very short time, something that it was totally unprepared for. Within only a couple of years, Lithuania has totally redirected its trade. Today close to 50% of Lithuania's export go to western markets mainly the EU and only 15% to former CIS countries. Lithuania's export has so far mainly consisted of raw materials or semi-manufactured products such as textiles. More refined products do not reach the levels of the EU and are consequently exported to former USSR. Lithuania's most important trading partners are Latvia, Germany, and UK. Most important commodity groups are textile, electronic equipments, furniture and refined petroleum. (www.swedishtrade.se)

It is evident that Lithuania is at least as dependant as Estonia and Latvia on external trade for its economic growth and especially since its domestic demand continues to be very weak (in fact much weaker than its neighbors). Therefore, its future is dependant on further developments in foreign trade and the growth of exports and foreign investments.

4.4 WHY DO ECONOMIC REFORMS DEVELOP DIFFERENTLY?

There are a number of factors explaining the successful transition of Estonia. It has later become evident that Estonia has some important preconditioned advantages compared to Latvia and Lithuania. Firstly, the number of heavy industries located in Estonia was relatively small in comparison to its neighbors. Heavy industries demand much more capital and energy resources, which makes it much more complicated to adjust them to a market economy than labor and resource intensive industry that Estonia had a larger share of. As a result, preconditions in industry structure made it generally easier for Estonia to adjust its industries to a market economy. Furthermore, Estonia had an important advantage regarding its oil shale industry, making the country less dependant on imports of oil and electricity. Additionally, Estonia's transport infrastructure was well developed (as was Latvia's) which gave yet an advantage at the start of the transition period. (Norgaard, 1996)

Besides these factors, historical and cultural background plays a vital part in the development of a country. Although Estonia has been under German influence, it has more close historic ties to the Nordic countries, mainly due to the Danish and especially the Swedish dominance of the area. This has of course been one of the major factors influencing Estonia's development. (OECD, 2000) For Estonia's development, it has clearly been imperative to have Finland as a neighbor. The similarity of the Estonian and Finnish languages was essential especially at the beginning of transition. General ideas about what a market economy is, and how a democratic society works, were spread through the TV and other communication channels, which initiated an exchange of information. Additionally, the close economic links with Finland enhanced the

reorganization of foreign trade from east to west and the fast integration with the Western world, especially with the EU. (www.yahoo.com)

Although Latvia has been influenced both by the Nordic countries as well as more Central European countries such as Poland and Germany, Latvia mostly associates itself with the culture and ideas of Northern Europe. (Norgaard, 1995) Latvia, together with Estonia, had a relatively large share of immigrants from Russia during the Soviet Union period. Latvia has been significantly shaped and affected by this mass immigration, which was larger here compared to the other Baltic countries. As a result, Latvia has approximately 32%[2] Russians and additionally around 7%[2] Belarussians and Ukrainians and has had much larger problems to create a national identity. (OECD, 2000)

Due to a quite homogenous population, Lithuania has had fewer problems with the integration of minority groups compared to its neighbors. The Nordic countries have had less of an impact on Lithuania than they have on Estonia and Latvia since Lithuania has been mainly influenced by Central European culture and politics from Poland and especially Germany throughout history. (OECD, 2000) Lithuania has historically also been a much more rural society, with few factories, depending on agriculture for a long time. This resulted in quite different initial conditions for Lithuania in comparison with the two other Baltic countries. (Norgaard, 1996)

Afterwards, it has been stated that using privatization methods of open tenders and direct sales result in better corporate governance and stronger financial position in enterprises than mass privatization or insider deals. Additionally, the management know-how and access to financing of foreign investors has proved to boost the development of the enterprise sector in transition countries. These are essential factors in explaining Estonia's success in privatization while especially Lithuania has lagged behind due to its mass-privatization strategy and restriction of foreign investors. The creation of new private enterprises is also important in building a well-functioning market economy.

[2] According to www.csb.lv

Estonia's business climate has been considered especially favorable for entrepreneurs and new enterprises have accordingly been most frequent here. For Lithuania on the other hand, the ever-changing laws and regulations and red tape represent major obstacles for entrepreneurs. Further, a well-functioning and effective bankruptcy legislation to facilitate the competition between companies and force unsuccessful companies to insolvency, and in that way, improve the overall functioning of the market economy is vital. Again, Estonia has proved to be most successful to establish effective and strict bankruptcy procedures. (Lainela, 2000)

Finally, yet another factor in explaining the success of Estonia is its early and extensive attraction of FDI. FDI has certainly proved to play an important part in the development of transition economies, in the privatization of state-owned enterprises, in the financing of current accounts and in the overall building of a market economy with important inputs of know-how in management, marketing and restructuring. Thanks to Estonia's liberal attitude from the beginning, FDI has clearly facilitated the growth of the Estonian economy. (Juurikkala, 2001)

4.5 CHAPTER SUMMARY

So far, it seems as if Estonia has undoubtedly been "the shining star" of the Baltic states. As a result of initial differences in historic background, industry structure and choice of reforms, Estonia has managed to take the most direct and unproblematic path towards a market economy. Thus, it is clear that it is not only the speed of reforms that has made Estonia so successful and hence it is also difficult to draw any conclusions concerning the optimal speed of transition. Although, having entered the 20th century, it seems as if it will not be too long until the three Baltic countries are on even ground. Latvia is gaining ground although Lithuania still is lagging behind. However, the difference is not so much in the GDP level per capita, but rather in trade and investment. Estonia's foreign trade as a percentage of GDP is about twice the size of its neighbors and FDI per person is also higher. Still, it is only a question of time until Latvia and Lithuania will catch up with Estonia. (The Economist, Sep 1 2001)

5. PRESENTATION AND ANALYSIS OF STATISTICAL DATA

The aim with this chapter is to discuss research problem one and thus, give an overall picture of the Baltic countries' foreign trade with major partners from the beginning of the 1990's and until today. The idea is to illustrate any patterns of trade that may have occurred during this period of time. In addition, trade with the United Kingdom and the United States will be more closely examined in terms of different commodity groups in value. Similar graphs will be presented in quantity in appendix p.131-132. Finally, a calculation example of different possible growth scenarios is presented.

5.1 GENERAL VIEW OF THE TOTAL FOREIGN TRADE OF THE BALTIC COUNTRIES

At the beginning of the 1990's, there were high expectations that the foreign trade of the Baltic would develop at a quick pace, opening up opportunities for trade with Western neighboring countries. However, foreign trade has proved very difficult and much more time consuming to alter than was anticipated. The initial reason for this was of course the downturn of economic activity and industrial production caused by the disruption and fall of the centrally planned system. Another obstacle was the lack of experience in dealing with the West since most trade had been inter-regional trade within the USSR. Nevertheless, the Baltic countries soon understood the importance of being economically and politically independent from Russia, and with time their trade with the East (Russia/USSR) has diminished in favor of the Western countries notably the EU.

Thus, at the beginning of the 1990's, Estonia, Latvia and Lithuania's foreign trade was directed towards Russia and other former USSR[3] republics. As a

[3] Former USSR here refers to the CIS republics, among others Estonia, Latvia, Lithuania, Russia, Belarus and Ukraine.

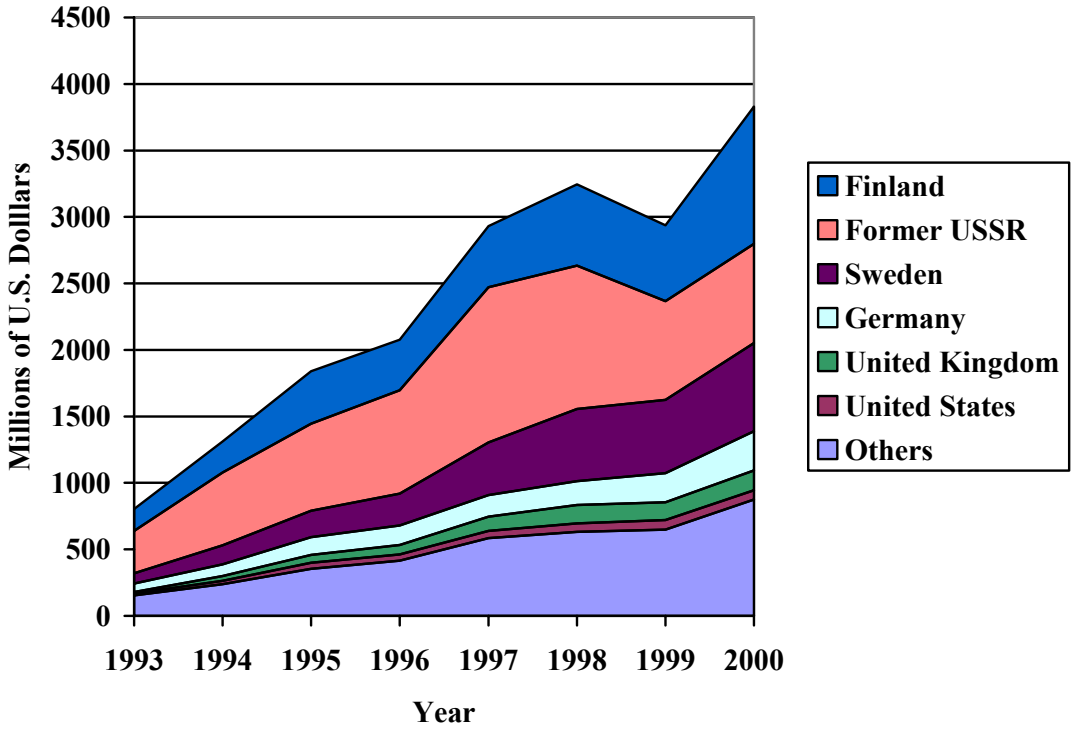
market-oriented foreign trade was non-existant at the beginning of the transition period, foreign trade initially increased immensely. This explains a great deal of the increase of exports and imports to the former USSR up until the mid-1990's. However, it is important to realize that the USSR in this case includes exports to the neighboring countries in the Baltics as well. Counting the USSR as a unity it still constitutes a significant part of the Baltic countries' foreign trade today.

Comparing exports from and imports to the Baltic countries it is obvious that imports have increased at a much faster pace than exports and therefore imports constitute a much larger share of the total foreign trade. This trend is only natural for a transition country. First of all, in an environment that has been kept closed to the outside world, all kinds of products are needed in the reconstruction and development of the countries. Secondly, as overall conditions improve the urge for westernized products that were earlier not available increase. Thirdly, raw materials are a rather scarce resource in the Baltic region and are obviously needed in production. Consequently, this has of course resulted in a large imbalance of trade. In the year 2000, the total negative trade balance was 1226 Million USD[4] in Estonia, 999 Million in Latvia and 1610 Million in Lithuania. Compared to 1993, Estonia had a trade deficit of 91 Million USD while Lithuania's trade deficit was 222 Million USD. In contrast Latvia had a positive trade balance of 80 Million USD in 1993.

[4] All numbers in this section will be presented in Million USD.

Estonia's total exports in the year 2000 amounted to 3829 Million USD. Of the Western countries, Finland and Sweden were from the beginning two of the most important trading partners due to both geographical as well as historical reasons. In 2000, Finland held 1033 Million USD of the export value while the exports to Sweden was valued to 663 Million. The United Kingdom and the United States have so far been quite insignificant as trading partners for Estonia. In 2000, the exports to the United Kingdom totaled 150 Million USD whereas the United States amounted to 70 Million USD of total exports.

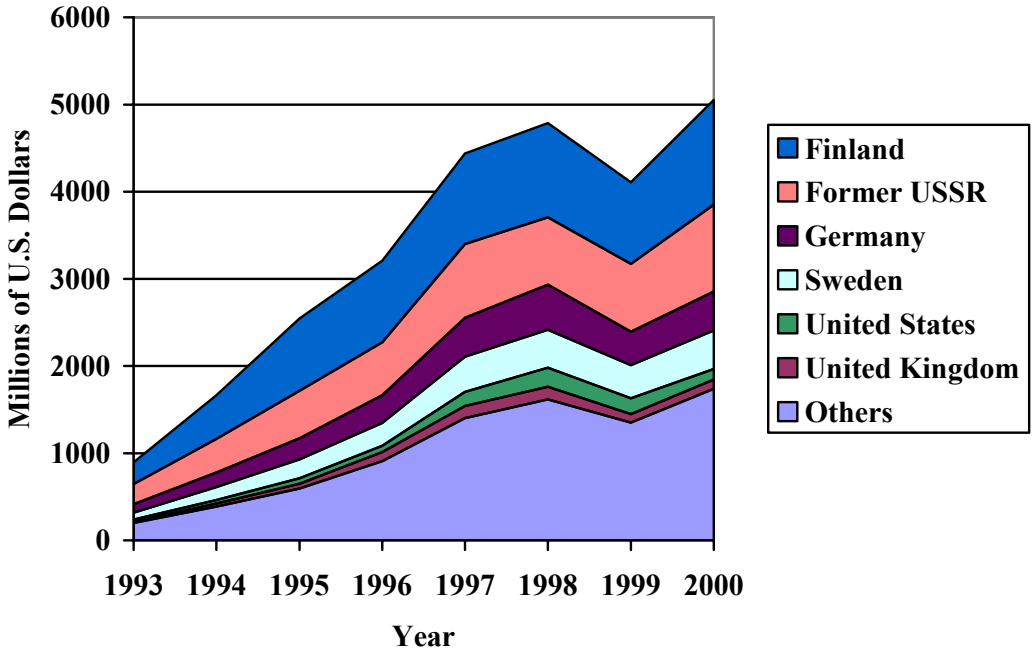
Fig. 2 Estonia's total exports by countries of destination 1993-2000



Source; IMF, Direction of Trade Statistics, 2001.

Total imports to Estonia amounted to 5055 Million USD in 2000. Excluding USSR, the largest import partners in the year 2000 were Finland (1205 Million USD) and Germany (446 Million). Imports from the United Kingdom amounted to 110 Million in 2000 while imports from the United States represented 121 Million USD.

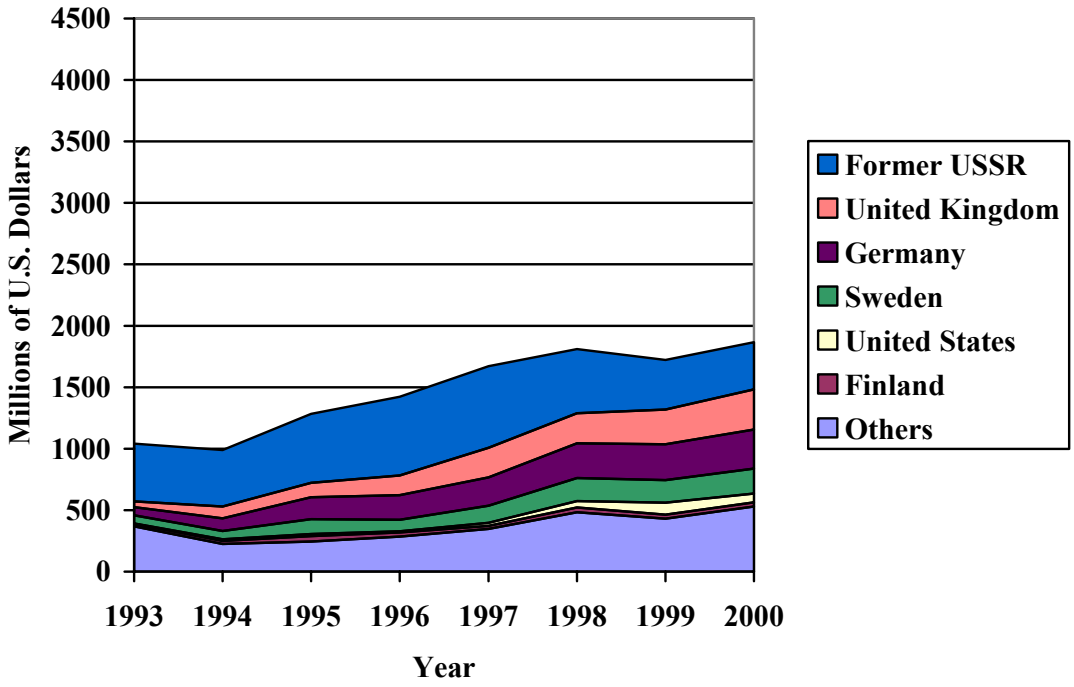
Fig. 3 Estonia's total imports by countries of origin 1993-2000



Source; IMF, Direction of Trade Statistics, 2001.

Latvia's total exports amounted to 1866 Million USD in 2000. Latvian exports have a more even pattern of equally large trade partners, where the two largest Western trading partners are the United Kingdom (324 Million) and Germany (320 Million). Latvia's exports to the United States were valued to 71 Million in 2000, which makes the United States an equally unimportant trading partner for both Estonia and Latvia.

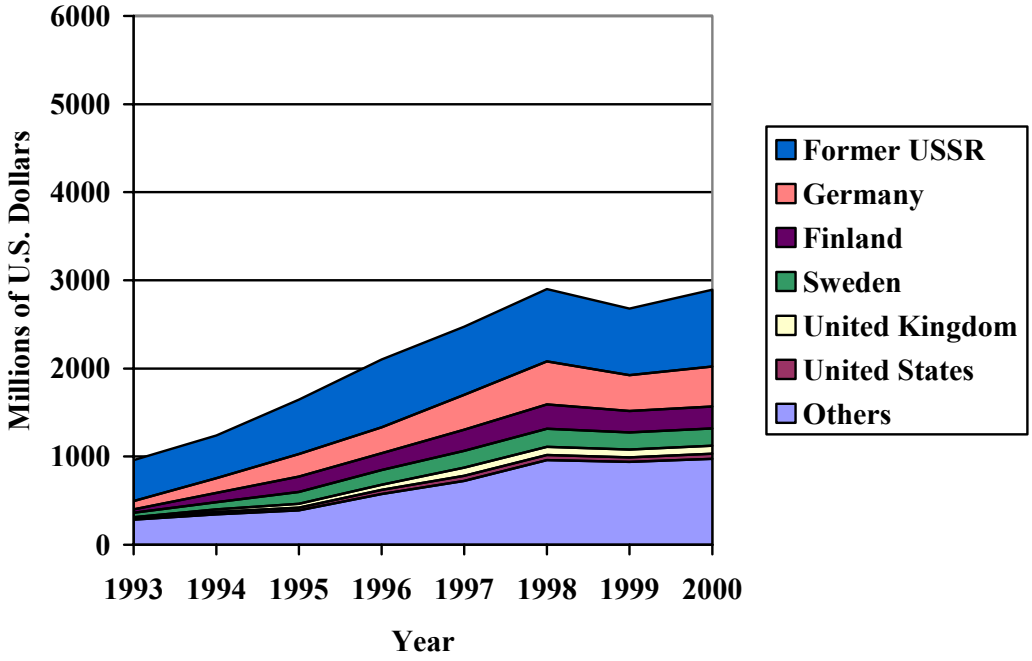
Fig. 4 Latvia's total exports by countries of destination 1993-2000



Source; IMF, Direction of Trade Statistics, 2001.

The Latvian total import value was amounted to 2895 Million USD in 2000. Latvia's two largest Western import partners in 2000 were Germany (453 Million USD) and Finland (253 Million). The United Kingdom constituted for 92 Million USD of total imports while the United States amounted to 58 Million USD.

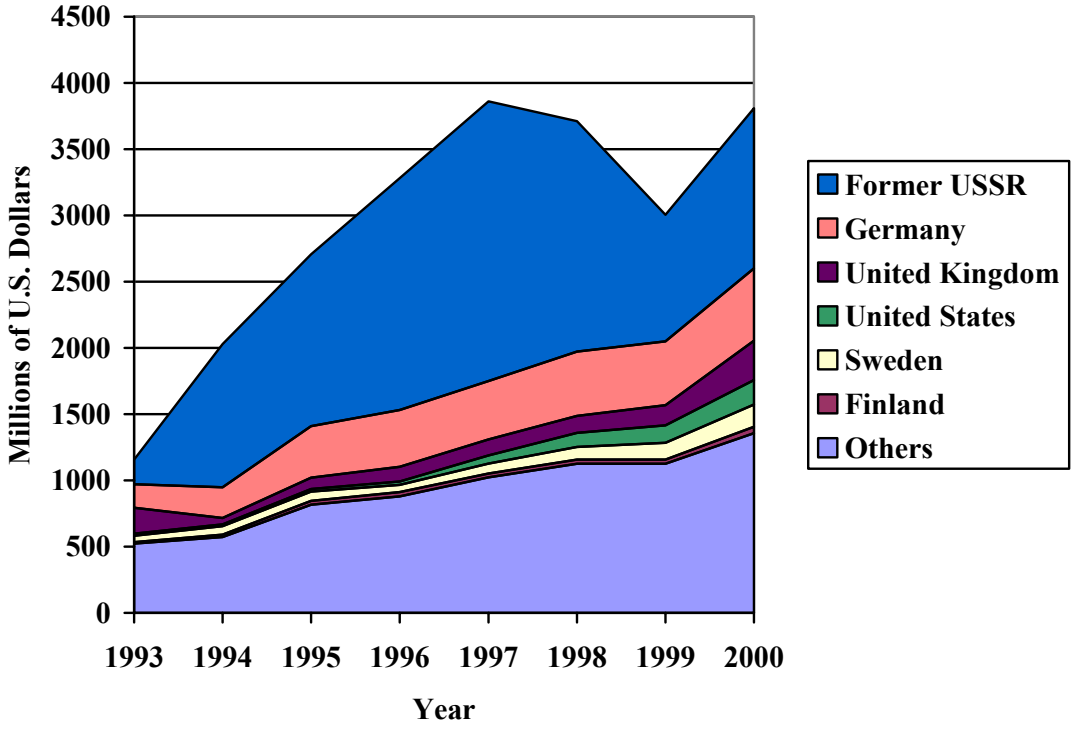
Fig. 5 Latvia's total imports by countries of origin 1993-2000



Source; IMF, Direction of Trade Statistics, 2001.

Lithuania's export value amounted to 3808 Million USD in 2000. Germany and the United Kingdom represent the most important Western trading partners. The exports to Germany totaled 546 Million USD in 2000 and 297 Million USD were exported to the United Kingdom. Finally, it is notable that the United States today is the fourth largest trading partner of Lithuania, exports totaled 185 Million USD to this market in 2000.

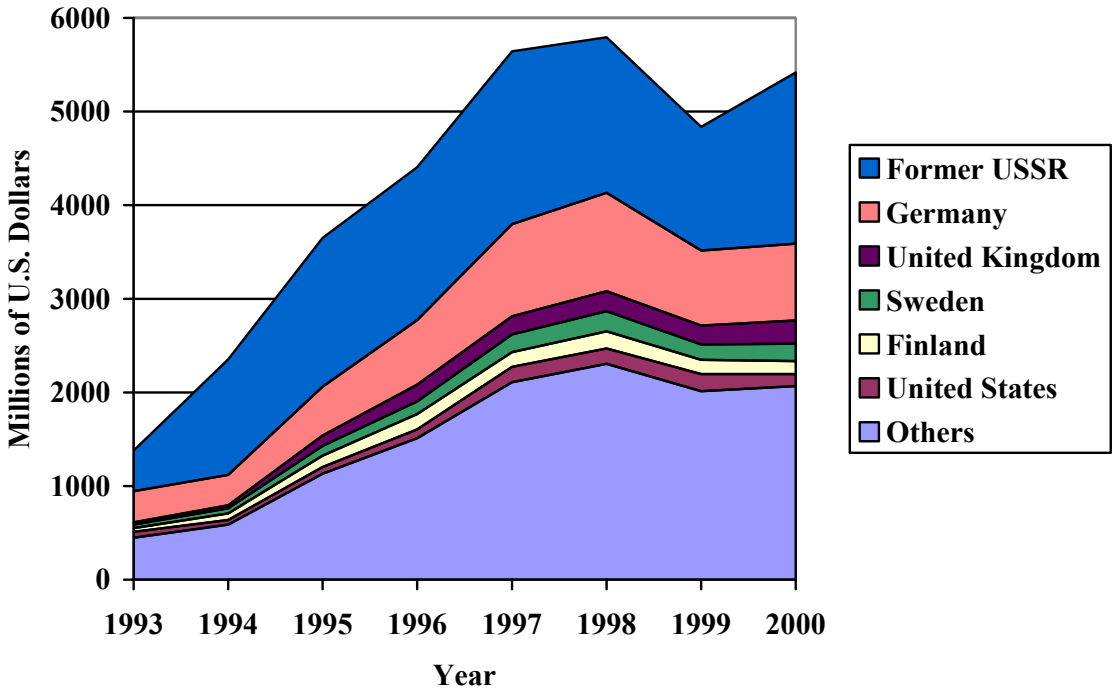
Fig. 6 Lithuania's total exports by countries of destination 1993-2000



Source; IMF, Direction of Trade Statistics, 2001.

In 2000, Lithuania imported a total of 5418 Million USD. Imports from Germany totaled 821 Million USD whereas imports from the United Kingdom totaled 246 Million. Goods valued to 130 Million USD were imported from the United States.

Fig.7 Lithuania's total imports by countries of origin 1993-2000

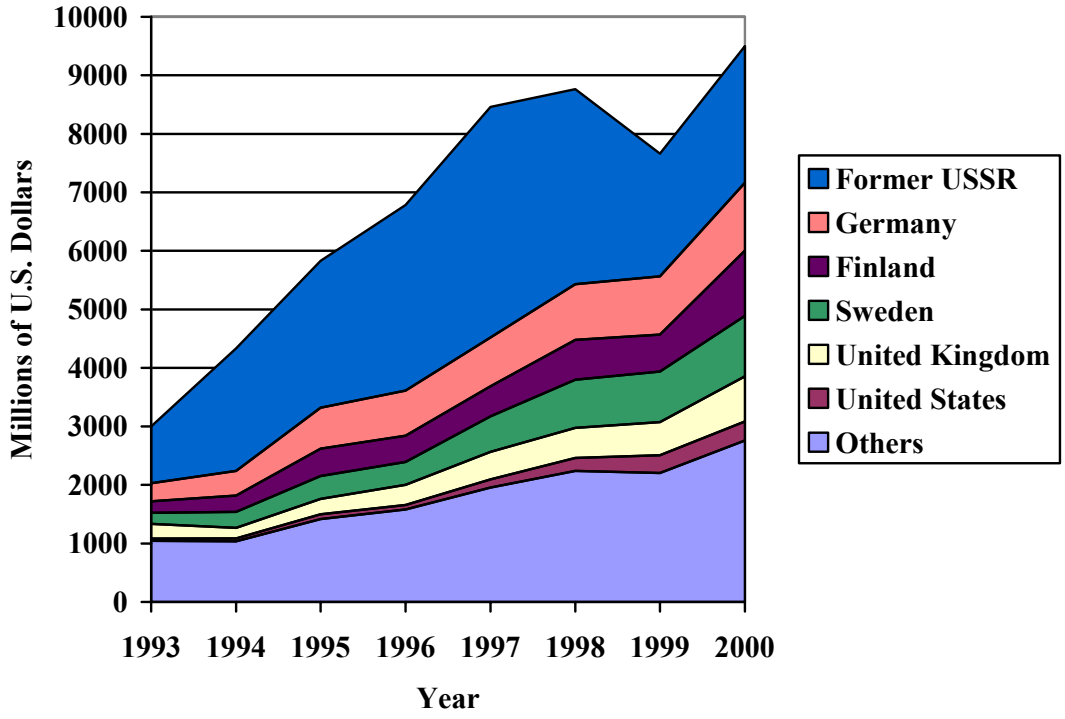


Source; IMF, Direction of Trade Statistics, 2001.

To gain a more comprehensive picture of the total Baltic countries' foreign trade, this part is concluded with two graphs. The Baltic countries total exports totaled 9503 Million USD whereas imports amounted to 13368 Million. Thus, the negative trade balance is quite substantial. Concerning the Baltic exports and imports it can be concluded that subsequent to USSR Germany, Finland and Sweden represent the most essential destinations and origins of trade. From being close to non-existant the United States has become an increasingly important trading partner of the Baltic states. Even if the trade value for United States seems a fairly modest one has to consider the substantial increase since 1993. However, when the United Kingdom and the United States are put together, these partners actually constitute a larger export partner of the Baltic countries than Sweden, amounting to 1097 Million USD in 2000 and thus

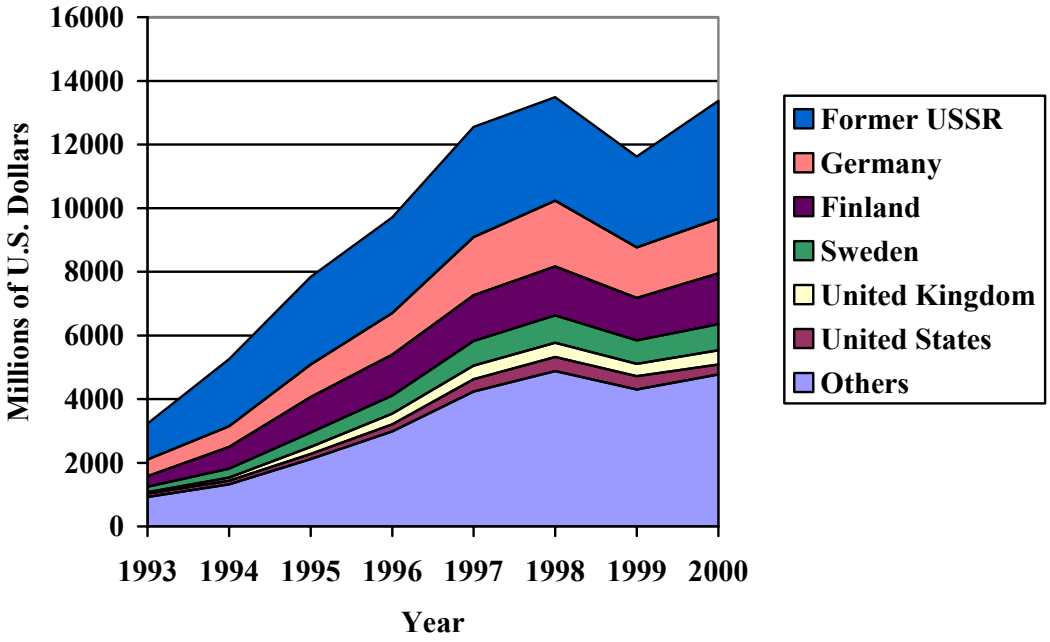
placing them close behind Finland and Germany. In 1998 the Russian economic crisis hit the Baltic countries and severely damaged and affected the foreign trade growth, which is clearly visible in 1999 figures.

Fig.8 Baltic total exports by countries of destination 1993-2000



Source; IMF, Direction of Trade Statistics, 2001

Fig. 9 Baltic total imports by countries of origin 1993-2000



Source; IMF, Direction of Trade Statistics, 2001

5.2 COMPOSITION OF GOODS

The next step in the research of statistical data was to separate total trade into different commodity groups. In the graph below, the different goods have been divided into three commodity groups; raw materials, base-manufacturing and finished manufactured goods (machinery, automotives and consumer goods).

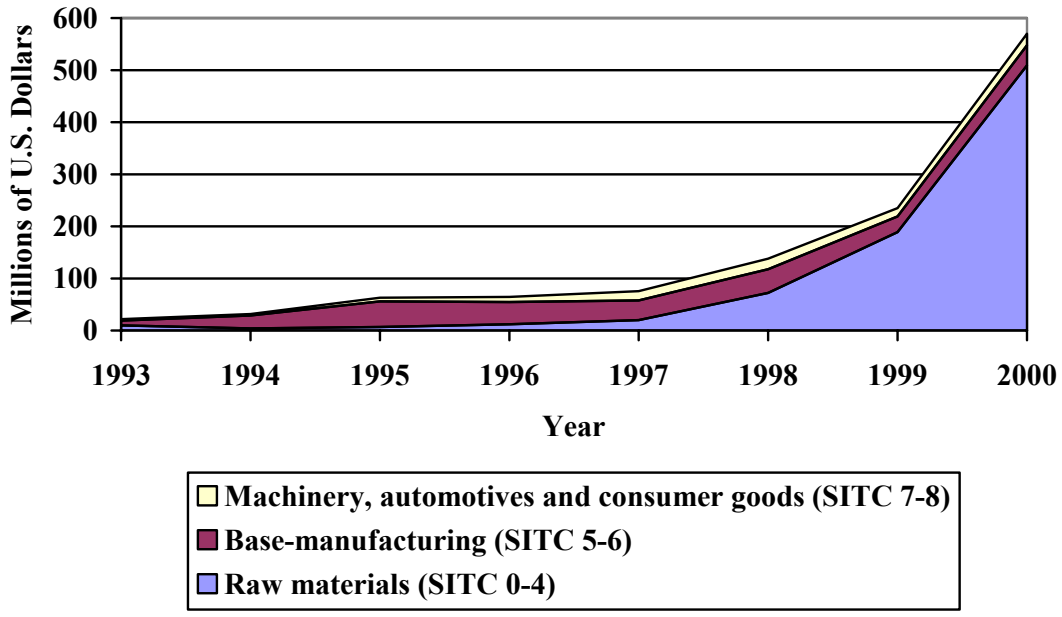
Raw materials	Food and live animals, beverages and tobacco, crude materials (rubber, timber, sawn wood, minerals), mineral fuels and oil, animal and vegetable oils.
Base-manufacturing	Chemicals, paper, steel, metal products, textiles.
Manufacturing	Machinery and transport equipment, electronic equipment, vehicles, furniture, clothing.

From this point forward, the term "manufactured goods" refers to both base-manufacturing and finished manufactured goods.

However, when comparing the different international sources IMF and OECD, it became obvious that the latter includes transit trade to and from Russia. Transit trade consists mainly of raw materials such as oil and minerals. The results were misleading to such an extent that research would have been less reliable if raw materials were included. Therefore, the decision was to exclude this commodity group from further investigation.

The graph shows an evident example of what the result of including raw materials would be. In this case, Estonia's total exports to the United States seem to amount 570 Million USD. Yet, compared to the previous graph by IMF (see p.59) Estonia's exports only amount to 70 Million USD. As shown by the graph below the misleading factor is hidden in raw materials belonging to SITC 3 (mainly fuels and oil) which in this case amount to 500 Million USD.

Fig.10 Estonia's total exports by commodities to the United States including transit trade 1993-2000



Source; OECD, ITCS International Trade by Commodities Statistics, 2001.

5.2.1 TRADE WITH THE UNITED KINGDOM AND THE UNITED STATES

Considering the Port of Göteborg AB and its geographical location, the United Kingdom and the United States have been chosen for further analysis of their trade with the Baltic countries. Sweden has also been included as a reference country to gain a picture of the current transportation of goods between the Baltic countries and Sweden.[5] In this section, the Baltic countries are treated as one unity, as are the United Kingdom and the United States. The main reason for this is that for the Port of Göteborg the combined trade flows between the Baltic countries and the United Kingdom and the United States are more interesting than the separation of trade on the different partners.

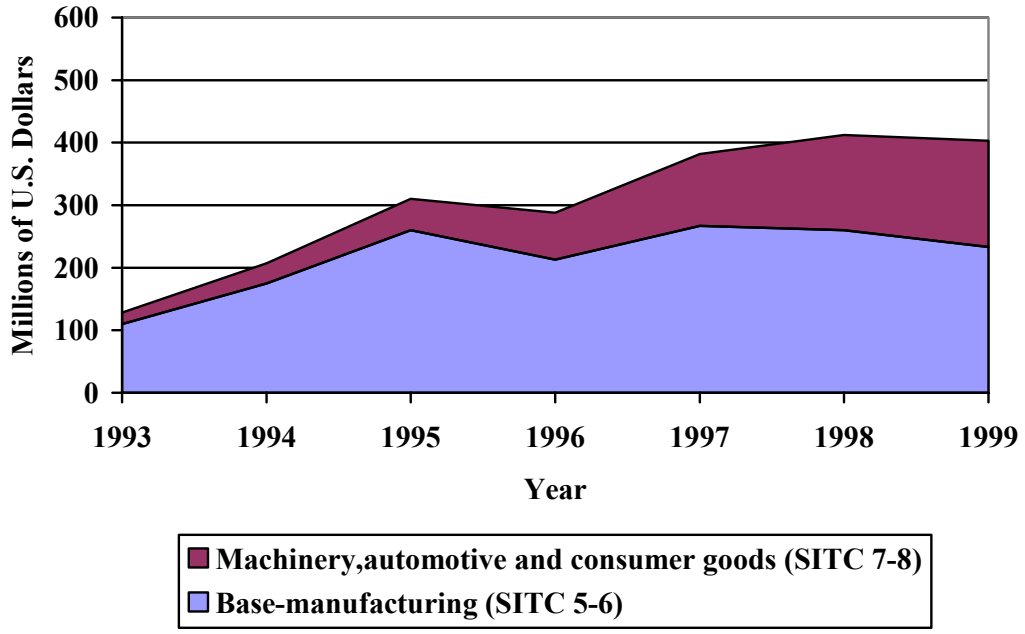
Taking a closer look at the foreign trade with the United Kingdom and the United States, it has been divided into basic manufactures and finished manufactured goods due to previous mentioned problems with transit trade. The purpose has been to present the development in value since 1993 and to identify any differences between these two groups. The most interesting commodity group from the perspective of the Port of Göteborg is finished manufactured goods (such as machinery, automotives and consumer goods). This group generates a much higher relative value compared with basic manufactures.

[5] The graphs of the trade with Sweden have been placed in appendix p. 133.

5.2.1.1 Exports

The Baltic countries' exports of finished manufactured goods and basic manufactured goods to the United Kingdom and the United States have grown considerably during the last decade. Today the Baltic countries export finished manufactured goods to a total value of 170 Million USD and basic-manufactured goods to the value of 233 Million USD to these two markets. The total export value of finished and basic manufactures consequently amounts to 403 Million USD. Even if basic manufactures constitute the largest group, finished manufactures had an impressive growth since 1993 when it totaled only 18 Million USD. Thus, the difference between the two groups is steadily decreasing.

Fig.11 Baltic exports of manufactured goods to the United Kingdom and the United States 1993-1999

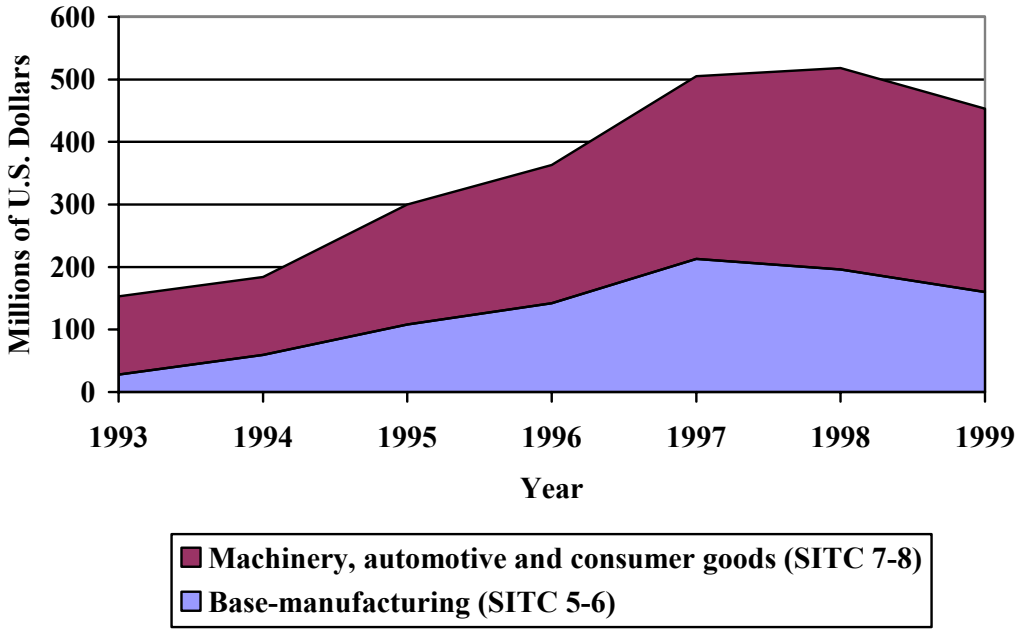


Source; ITCS International Trade by Commodities Statistics, OECD, 2001.

5.2.1.2 Imports

The import value of the Baltic countries exceeds the value of their export. In 1999 the import value of finished manufactures and basic manufactured goods amounted to 453 Million USD, which resulted in a trade deficit of 50 Million USD. Contrary to exports, imports are dominated by finished manufactured goods (293 Million USD in 1999) while basic manufactured goods only represent a total value of 160 Million USD.

Fig.12 Baltic imports of manufactured goods from the United Kingdom and the United States 1993-1999



Source; ITCS International Trade by Commodities Statistics, OECD, 2001.

5.3 FUTURE TRADE SCENARIOS

In order to put together a basis for the prediction of foreign trade in the Baltic countries, a calculation example of possible scenarios is presented in this section. The calculation is based on the Baltic's trade of manufactured goods to the United Kingdom and the United States and is applied both for exports and imports. Further, the scenarios are based upon three main assumptions regarding the potential growth rates of the next five years. However, this

should not be considered as a trustworthy potential analysis but rather as a simple calculation example.

In the first assumption, growth will continue at the same average annual growth rate as the Baltic exports and imports of manufactured goods to the United Kingdom and the United States did during 1995-1999 Unfortunately, the statistics of OECD did not cover the year 2000 for the United Kingdom. The second assumption is based on a fifty percent higher growth rate than in the first case. The fifty percent growth rate is randomly selected, but is chosen to indicate the extreme positive versus negative growth rate. The third assumption is on the opposite based on a fifty percent lower growth rate than the growth rate in assumption one. Thereafter, two sub-assumptions were subordinated each main hypothesis. In the first sub-assumption, growth is predicted to grow according to the three main assumptions respectively. In the second sub-assumption, growth is calculated to grow at a fifty percent higher growth rate than in the first sub-assumption.

5.3.1 EXPORT SCENARIOS

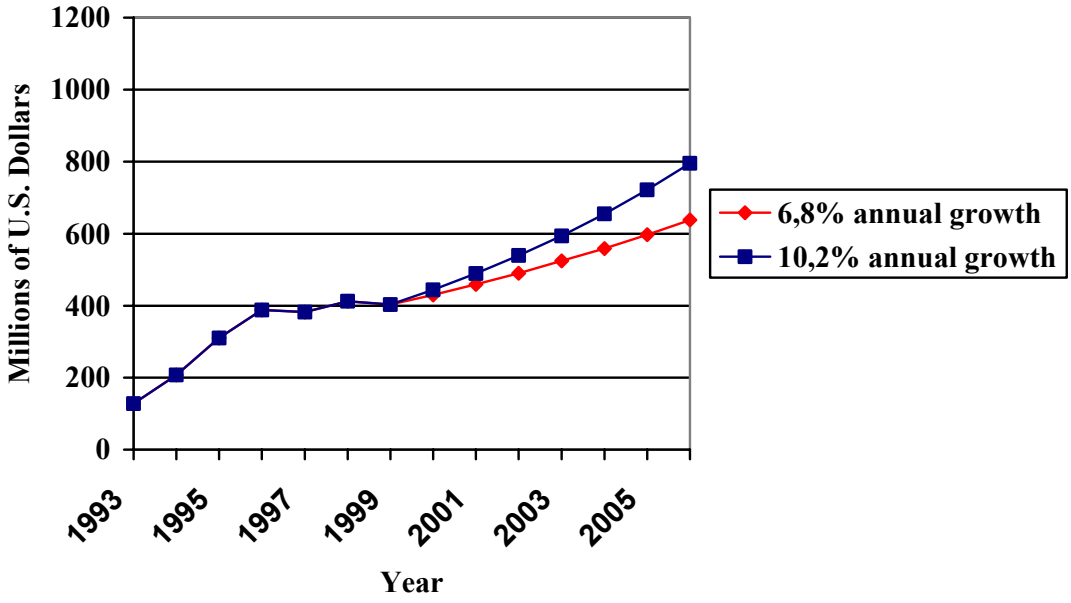
Scenario 1 Exports; Based on the current trade growth

Main assumption:
Exports will grow in compliance with an average yearly rate from 1995 to 1999. Baltic exports of manufactured goods to the UK and US have increased from 310 Million USD in 1995 to 403 Million USD in 1999. Accordingly, the annual average growth rate amounts to 6,8%.

Sub-assumptions:

1) Exports to the United Kingdom and the United States are estimated to grow at the same rate, 6,8%, annually through the year 2006.
2) Exports to the United Kingdom and the United States are assumed to grow at a 50% higher rate, 10,2%, annually through the year 2006.

Figure 13 Baltic exports of manufactured goods to UK and US 2000-2006 according to scenario 1



Source: own

Scenario 2 Exports; Based on a 50% higher growth rate

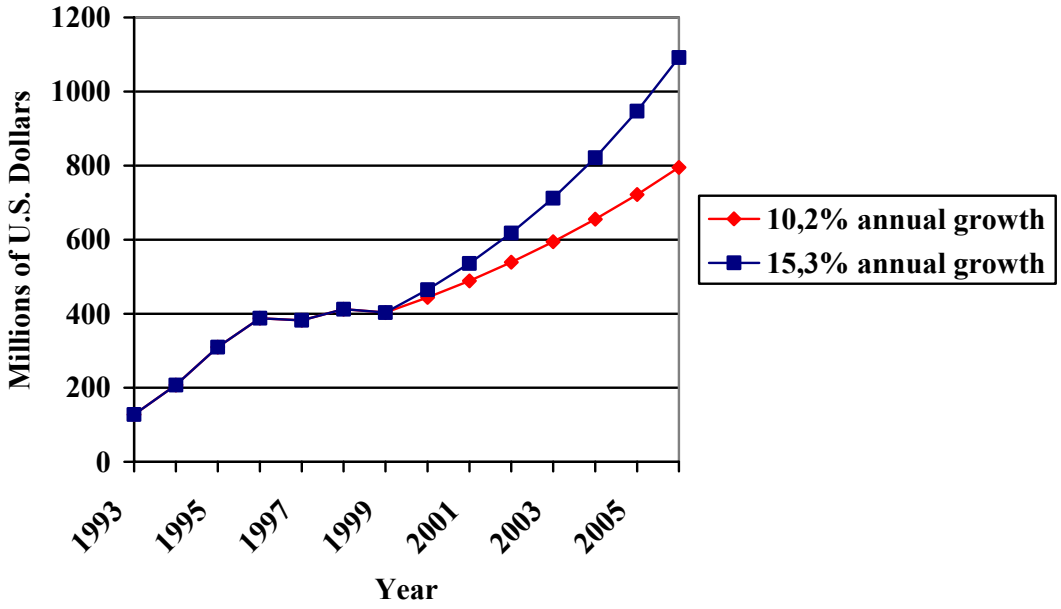
Main assumption:

Exports will grow annually at a 50% higher rate compared to the previous scenario. Thus, the annual growth rate amounts to 10,2%.

Sub-assumptions:

1) Exports to the United Kingdom and the United States are estimated to grow at the same rate, 10,2%, annually through the year 2006.
2) Exports to the United Kingdom and the United States are assumed to grow at a 50% higher rate, 15,3%, annually through the year 2006.

Figure 14 Baltic exports of manufactured goods to UK and US 2000-2006 according to scenario 2



Source: own

Scenario 3 Exports; Based on a 50% lower growth rate

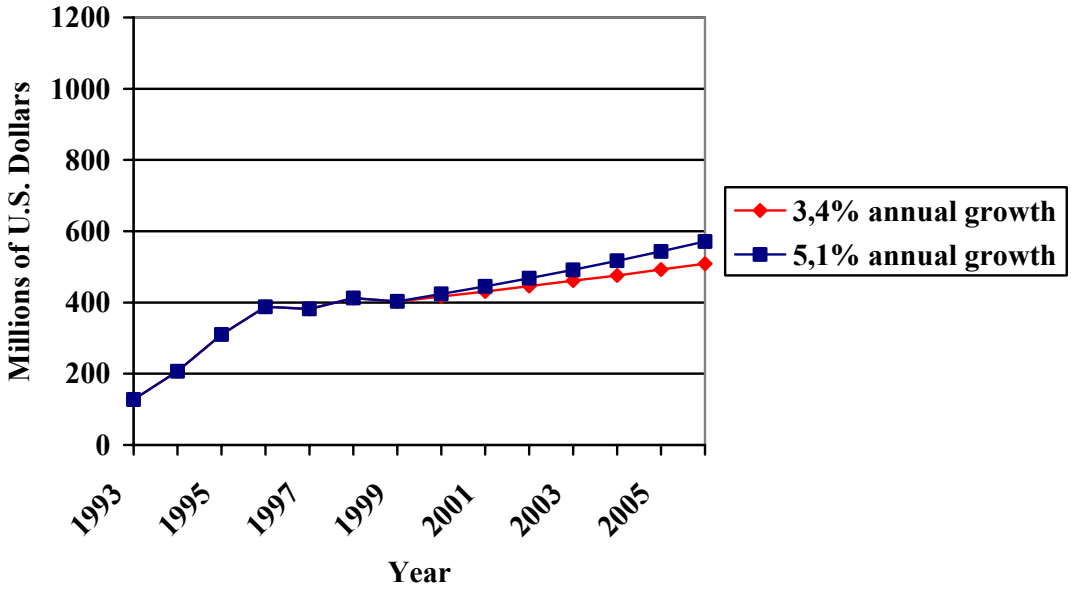
Main assumption:

Foreign trade will grow at a 50% lower rate compared to the first scenario. Thus, the growth rate amounts to 3,4%.

Sub-assumptions:

1) Exports to the United Kingdom and the United States is estimated to grow at the same rate, 3,4%, annually through the year 2006.
2) Exports to the United Kingdom and the United States is assumed to grow at a 50% higher rate, 5,1%, annually through the year 2006.

Figure 15 Baltic exports of manufactured goods to UK and US 2000-2006 according to scenario 3



Source: own

5.3.2 IMPORT SCENARIOS

Scenario 1 Imports; Based on the current trade growth

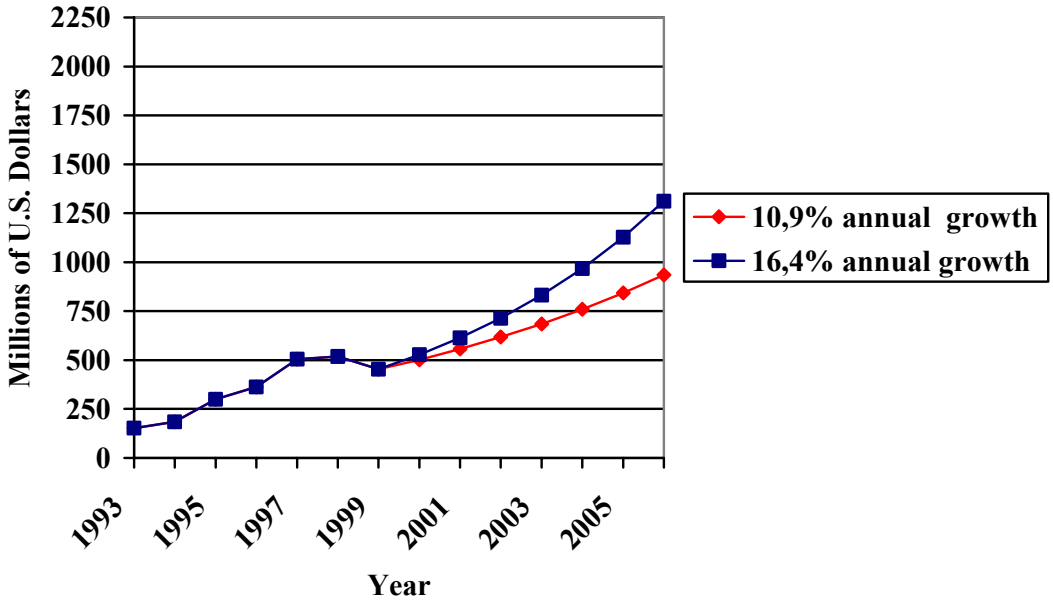
Main assumption:

Imports will grow in compliance with an average annual rate from 1995 to 1999. Baltic imports of manufactured goods to the UK and US have increased from 300 Million USD in 1995 to 453 Million USD in 1999. Accordingly, the annual average growth rate amounts to 10,9%.

Sub-assumptions:

1) Imports to the United Kingdom and the United States are estimated to grow at the same rate, 10,9%, annually through the year 2006.
2) Imports to the United Kingdom and the United States are assumed to grow at a 50% higher rate, 16,4%, annually through the year 2006.

Figure 16 Baltic imports of manufactured goods to UK and US 2000-2006 according to scenario 1



Source: own

Scenario 2 Imports; Based on a 50% higher growth rate

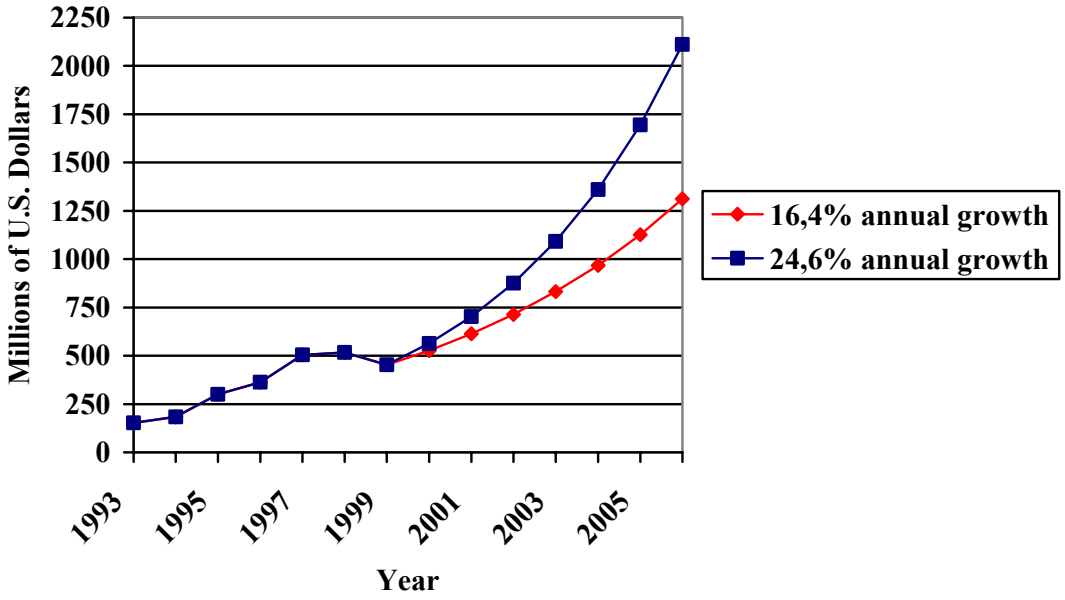
Main assumption:

Imports will grow annually at a 50% higher rate compared to the previous scenario. Thus, the annual growth rate amounts to 16,4%.

Sub-assumptions:

1) Imports to the United Kingdom and the United States are estimated to grow at the same rate, 16,4%, annually through the year 2006.
2) Imports to the United Kingdom and the United States are assumed to grow at a 50% higher rate, 24,6%, annually through the year 2006.

Figure 17 Baltic imports of manufactured goods to UK and US 2000-2006 according to scenario 2



Source: own

Scenario 3 Imports; Based on a 50% lower growth rate

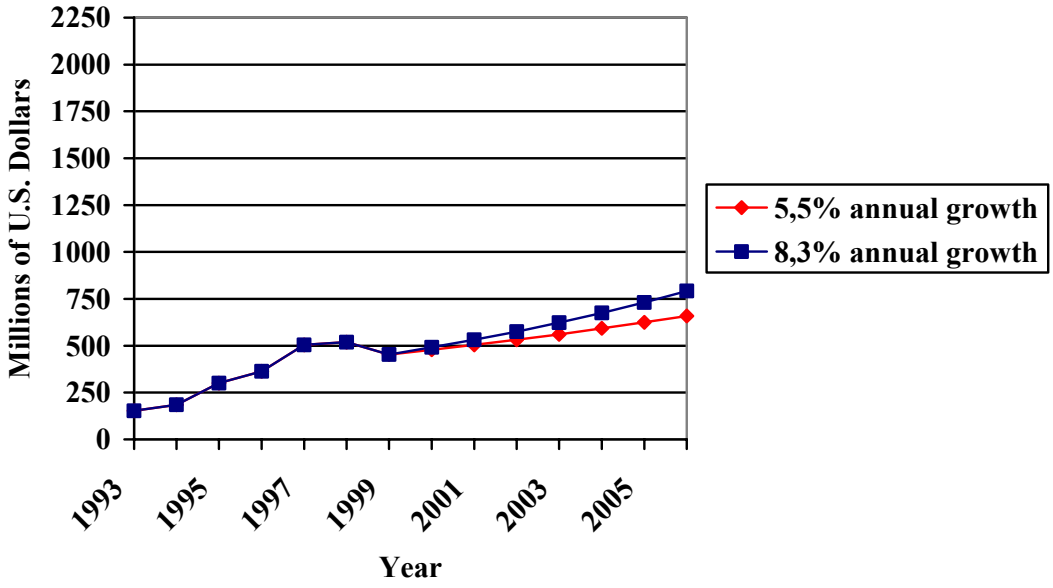
Main assumption:

Imports will grow at a 50% lower rate compared to the first scenario. Thus, the growth rate amounts to 5,5%.

Sub-assumptions:

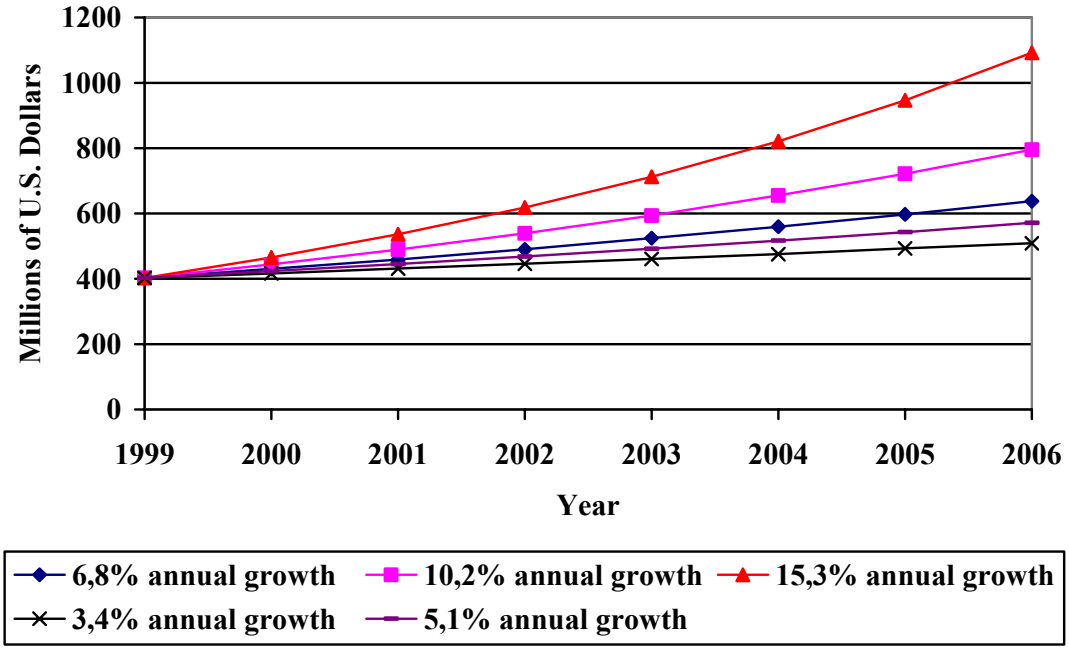
1) Imports to the United Kingdom and the United States is estimated to grow at the same rate, 5,5%, annually through the year 2006.
2) Imports to the United Kingdom and the United States is assumed to grow at a 50% higher rate, 8,3%, annually through the year 2006.

Figure 18 Baltic imports of manufactured goods to UK and US 2000-2006 according to scenario 3



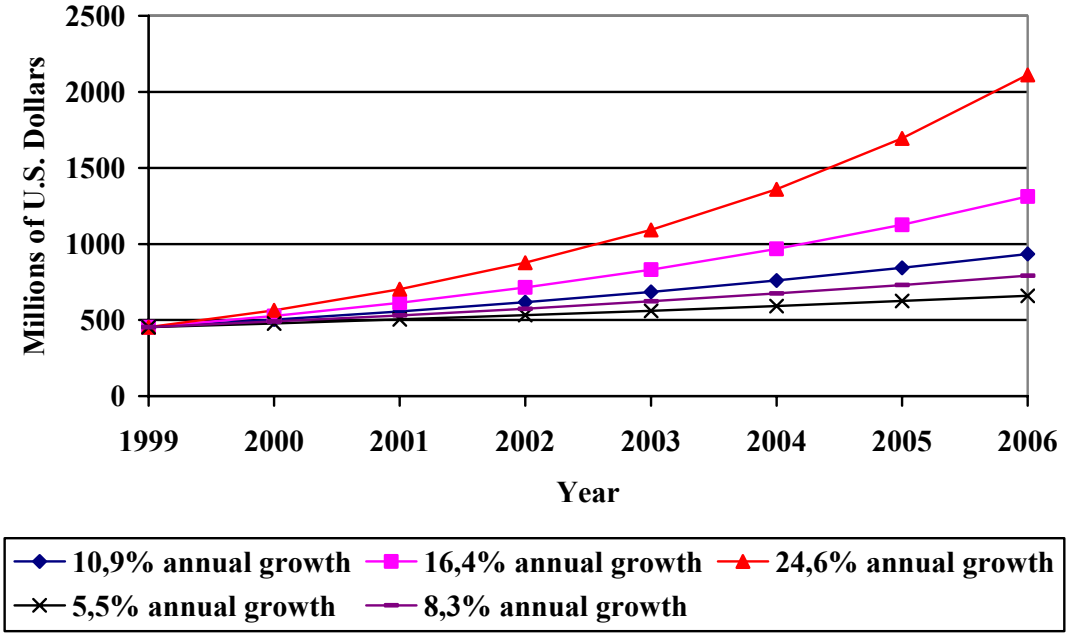
Source: own

Figure 19 Compound estimate of Baltic exports of manufacturing goods to UK and US 2000-2006



Source: own

Figure 20 Compound estimate of Baltic imports of manufacturing goods to UK and US 2000-2006



Source: own

5.3.3 CONCLUSIONS

In accordance with the theory of geographical proximity, the development of the Baltic countries' trade naturally started with the nearby countries and will gradually spread to a wider geographical area. Accordingly, as foreign trade of the Baltics develop, it is reasonable to assume that that it will increase substantially towards the United Kingdom and the United States in a longer time perspective. However, this does not mean that the trade value with geographically closer trading partners (Sweden and Finland) will decrease in a five-year period, possibly only that their importance will diminish due to a more equal division of trade on a larger number of countries.

The potential of both these large markets (United Kingdom and United States) is huge due to the size of their population compared to some of the most important trading partners of the Baltic countries today. However, the distance to especially the United States must be taken into consideration as a major obstacle, resulting in above all considerable transportation costs that affect trade substantially. The trade connection to above all the United States is evidently quite undeveloped which gives it potential for further development in the future. Although the United Kingdom belongs to one of the most significant trading partners of Latvia and Lithuania today, the value and volume are relatively modest with regard to the size of this market. Additionally, Estonia's relationship with the same market is so far almost unexploited which should provide considerable potential for the future.

The Baltic industries have to go through a gradual development towards more finished manufactured goods in order to increase its potential for the future. Consequently, concerning the two relevant commodity groups in this study, the growth of these goods should realistically be considerably faster in the future due to the initially modest share of manufactured goods. Due to the supposedly great potential of trade with the United Kingdom and the United States, it should be reasonable to assume that the export growth rate to the United Kingdom and the United States will increase significantly above the average growth rate of 6,8% percent (the diamond-shaped curve in the figure above).

Consequently, exports are assumed to grow in accordance with the steepest scenario in the graph, 15,3%.

6. PRESENTATION OF CASE COMPANIES AND ORGANIZATIONS

The four case companies will be presented in this section. The presentation will include their main existing markets, with an emphasis on the United States and the United Kingdom, to gain an overview of the current situation, as well as the future potential of these markets. With the purpose of receiving a general picture of the current economic and trade situation in Estonia, as well as the further development, a number of interviews with interest organizations in the Estonian society were conducted. The organizations will be shortly presented at the beginning of this chapter. Additionally, this part of the thesis includes a couple of companies (Holmen and the Port of Tallinn) whose information is only relevant for the general development of foreign trade (and thus, not for the trade development with the United States and the United Kingdom).

6.1 ORGANIZATIONS

Estonian Trade Promotion Agency

The Estonian Trade Promotion Agency started operating in 1992. The organization's main task is to facilitate the growth of Estonian exports by providing mainly informational services concerning foreign markets and export.

Estonian Investment Agency

The EIA was established in 1994. Its main goal is to promote FDI in Estonia and in that way enhance the economic growth of Estonia. Services provided by the EIA are both general country data as well as more specific information about a specific industry and about the legal environment.

Estonian Chamber of Commerce and Industry

The Estonian Chamber of Commerce is a private, non-profit organization that is voluntarily for companies to join. The Chamber was first established in 1925,

closed in 1940 but reestablished in 1989. Currently, it has 334 members, which accounts for about 12% of all registered companies in Estonia. All members are small or medium-sized companies. Potential members have to be registered in Estonia. The Chamber's works with the development of entrepreneurship, has a frequent dialogue with the state and the government and contributes to the development of Estonian legislation.

Swedish Trade Council

The Swedish Trade Council is represented in 35 countries with the purpose of enhancing international growth of Swedish companies. Some of the Council's main tasks are to map potential international markets as well as assisting in the matching of domestic partners (agents, distributors or customers).

6.2 KRENHOLM VALDUSE AS

The Krenholm Group was founded as Kreenholm Manufactory in Narva in 1857. Today, Krenholm is a vertically integrated textile mill company including the subdivisions of spinning, weaving, finishing (dying and printing) and sewing. Additionally, Krenholm Terry Cloth, which produces terry cloth (used in towels) and Krenholm Service, which provides service to all production units, are also included in the Krenholm Group. Krenholm is the largest industrial company and by far the largest textile company, and textile exporter, in Estonia, with an annual turnover of approximately 100 Million USD and around 4800 employees in 2000. Since 1994, Krenholm is 100% owned by the Swedish company Borås Wäfveri AB, which has played an essential role in the development of the company. Since privatization, Krenholm has been completely reorganized to function in a market economy. Having exported 90% to former USSR countries, Krenholm today exports 90% of its production to Western markets. 10% is sold on the domestic market (Estonia, Latvia and Lithuania) whereas nothing at all is sold to Russia. Borås Wäfveri AB has brought know how in marketing and management, valuable experience in restructuring as well as financial investments in machinery to Krenholm.

Krenholm produces 50 million meters of fabric a year (approximately 10 000 ton). Main products are commonly readymade home textile products made of 100% cotton or cotton-mixed fabrics, such as cotton diapers, curtains, bed linens, table cloths as well as terry bath towels and kitchen towels. Krenholm sell their products to other industries or companies (business to business) such as Gerber Childrenswear and Tegs in the United States, IKEA in Scandinavia and Marks & Spencer in the United Kingdom.

The raw material used in the production of textiles is raw cotton or cotton fiber. Originally, the cotton is imported from Uzbekistan and Tajikistan, although Krenholm buys it from the cotton stock exchange market in Riga. Only some minor material such as plastic buttons is imported from western countries.

6.2.1 MAIN MARKETS AND FUTURE POTENTIAL

The most important markets for Krenholm are the United States, Scandinavia (Sweden, Norway, Finland and Denmark) and Germany. Markets of less importance today are France, Belgium, Holland and the United Kingdom. 22% of the annual turnover is exported to the United States and Canada, which makes North America Krenholm's most significant trading partner. The company holds 67% of the niche market of cotton diapers in the USA, which undoubtedly makes this a vital market for the company. Deputy Manager Anatoly Ilkevich, expects this market to be equally significant for Krenholm in the near future, if not even more important than today. The Scandinavian market is of course also a large market, which Krenholm provides with ready-made products such as curtains, bed linen, tablecloths and towels and where IKEA is an important customer. Germany is a somewhat different trading partner, where Krenholm supplies the public sector with institutional products such as bed linen for hospitals and medical clothes for doctors. Still, the same products as are sold to the consumer market in Scandinavia are also sold in Germany although not to the same extent.

The United Kingdom is not an important market for Krenholm today. However, Ilkevich considers this market to have considerable future potential. Accordingly, Krenholm hopes to see a substantial increase of sales to the

United Kingdom within a short period of time and estimates the future exports to the UK to account for approximately 10% of the total turnover. Products currently sold on the UK market include grey cloth although more refined products similar to the other markets, (including textile accessories for kitchen and bathroom), are sold as well.

"*Within the next five year period, Krenholm will have stronger sales channels, a well-established sales network, big and reliable partners in Europe and around the world and also an established brand name. We will be able to sell products under the Krenholm name*"(Anatoly Ilkevich, Deputy Director).

Krenholm's growth up until today's world recession has been amazing, amounting to around 20-25% of the total turnover for the past five years. The next five years will be much more difficult and it will probably be impossible to reach the same numbers. To grow in the future, Krenholm needs to increase its know-how and professional effort in the production. Although the future is highly insecure and accordingly very difficult to predict, Ilkevich is still positive about the future and expects further growth.

6.3 BALTEX 2000

Baltex 2000 is a spinning and weaving company founded in 1899. In 1994 the company was privatized and bought by Tolaram Investments, which is an international group with the headquarters in Singapore and operations in countries in Asia, Africa, Europe and America. The Tolaram group is engaged in diversified activities ranging from its core business of manufacturing textiles, fibers and polymers to trading distribution, pulp and paper and real estate. Baltex is still a largely independent company, responsible for its own economy and decision-making. With an annual turnover of 30 Million US Dollars the company is the second largest textile company in Estonia. The company's products are woven fabric such as cotton grey yarns and fabrics. The customers are manufacturing companies.

Baltex imports its raw material, mostly raw cotton, from the world markets, most important is however Uzbekistan, Egypt but also the US. The port in Riga

is a very important hub/center for the trade with cotton from the Far East to the West.

6.3.1 MAIN MARKETS AND FUTURE POTENTIAL

Main markets for both cotton grey yarn and fabrics are Finland, Italy, the United Kingdom, Germany, Spain, Portugal, France, Denmark, Sweden and Norway. At present 98% of the output is exported to the EU countries or to its associate member countries. However, Finland and Italy alone constitute for fifty percent of the total exports. Within the next five to ten years the focus on the mentioned European markets will remain, even though there might be smaller changes. Italy will still be one of the far largest markets while Finland will decline in importance. Markets of increasing importance will probably be Germany, France and Spain and Sweden. Exports to the United Kingdom are today declining, however it will still remain an important market. This decline is a consequence of the difficulties for the textile industry in Europe to compete with the much lower prices in the Far East, and as a result many textile companies has closed down in the UK. The company has also looked into the possibilities to extend its exports to the US market.

"*We are also investigating the potential of the US market, however presently the textile industry in the US is under a lot of pressure since they are already experiencing the consequences of the coming world recession over there. Therefore, this market is completely out of the question today, but we believe there might be better potential in the US within a two or three year's period. Nevertheless, if this market will be pursued or not depends on what strategic decisions and investments that the company will engage in*" (Mati Sirkel, Business Development and Research).

In five years the company will be much more focused on customer service and quality. The company should also be able to deliver ready-made products to a whole new customer segment, which are the retailers. However, Mati Sirkel argues that the next few years will be really critical for the company because of the recession that he is certain will hit Europe. Another challenge for the

European textile industry in general, but of course also for Baltex 2000, is the fierce competition from the Far East.

6.4 FLEXA ESTI AS

Flexa is a family owned holding company originally started in 1972 in a small village in Denmark. Today, the company has manufacturing also in Estonia and China and sales organizations in the United States, Germany, France, Italy, Spain, United Kingdom and a sales representative handling the Scandinavian market. The core products are beds and furniture for children. The company has the main production and assembly in Denmark but since 1992 a subsidiary in Estonia (Flexa Eesti AS) has supplied parts to the Danish parent company. The Estonian furniture manufacturing company consist of a sawmill, production of components and raw materials for the beds and the production of knockdown furniture. The group turnover was 325 Million DKK in 2000. The same year the Estonian subsidiary had a turnover of 115 million Estonian Kroons (EKK) whereof 25 % is exported directly to customers, a percentage that is increasing every month.

One third of the production of components stays in Estonia for finishing production and assembly within the Kadrina-program, while the rest (approximately 65%) is exported to Denmark for the production of the Flexa-program. Both programs focus on beds and children furniture, however the Flexa-program is very expensive with a lot of services and marketing support while the Kadrina-program is a little bit inferior in quality, sold cheaper without marketing support and mainly in containers. The Flexa-program is accordingly always sold through Denmark, and only the Kadrina products are exported directly from Estonia to the customers. The only imports are logs/wood material from Russia.

6.4.1 MAIN MARKETS AND FUTURE POTENTIAL

The main markets of the Flexa group are Germany, France and United Kingdom. These markets alone constitute 60-75% of the company turnover. Other European markets are currently built up. In the United States only the

Flexa-program has been sold until just recently when the Kadrina-program also entered the market. However, there are still very small quantities that are exported directly from Estonia to the United States. Nevertheless, in the future, when the turnover of the U.S. market reaches around 50 million DKK a year (which could be reached within 2-3 years) the final process (of sanding, lacking and packing) could be moved there. An estimated 25 Million DKK of material worth would then be exported from Estonia to the United States. In this case, the exports would go directly from Estonia to the United States and not through Denmark. The United Kingdom will probably not be a large enough market to make this possible. In the UK Flexa Eesti sells and delivers its products directly to one mail order company. In the future, the company expects to do more business with the UK market. In five years the company here in Estonia will have taken over more of the production of finished goods.

6.5 AS TARKON

The company started out early in this century as a telephone-factory. However, during the years and with different owners the company diverged into a broad range of products. During the Second World War the factory was destroyed and the production was moved to Russia. After the war the factory was built up again. During the communistic period the company produced different secret military equipment such as flight recorders, “the black box”. However, after the fall of the Soviet Union the company had to find new products to manufacture. In 1996 the private company Tarkon AS was formed, where the Swedish company Hallbergs Sekrom AB today is a major shareholder with 85%.

Today, Tarkon specializes in contract manufacturing of fine mechanical components and of diverse assembly work including cables and electronics. The products belong to various telecommunications systems, in the car industry or to apparatus building. In Tartu the company have a milling, turning, service treatment, and sampling, and in Sweden Hallbergs Sekrom have logistics, turning department and product assembly. Raw materials are imported mostly from Sweden, UK and Germany.

6.5.1 MAIN MARKETS AND FUTURE POTENTIAL

Most of the company's market is in Sweden. A very small percent is sold to Finland. Today the company also has some customers in Denmark and Germany, and negotiations are going on with a potential customer in the United Kingdom. Around 60-70 percent of the production is exported. Madis Mädamürk does not see much potential on the U.S. market at least not in the near future. "*We have been in contact with the US market with these printers, but it is very difficult. Partly because they produce much of what they need by themselves, but we have tried and actually the price level was OK but then when you consider the transportation costs, the distance and the time for transport. Therefore I don't see that much potential in the US for the near future*" (Madis Mädamürk, Marketing Manager).

The future potential seems to be in Germany, Denmark and the United Kingdom. However, compared with Germany and Denmark, the UK market is the least promising market. "*The salary levels in the UK are much lower than in Finland, Sweden, Denmark and Germany. So to get customers from the UK we have to have a really low price and with the transport costs as well, the UK will not be our best market. Germany, Denmark and Finland are definitely becoming stronger*" (Madis Mädamürk).

"*Our vision for the future is to build up a "technological village" around us where we together with our suppliers can offer complete solutions to our customers. Already today, many of our suppliers are working around us here in Tartu, and the community will soon be a kind of a "Swedish community" with an extensive number of Swedish companies. These suppliers produce and supply us with among other things metal, plastic parts and glass components*" (Madis Mädamürk).

6.6 HOLMEN METS

Holmen was established in 1992. The company previously belonged to the Modo group and was called Modomets. In the year 2000 the name of the group was changed to Holmen and is today 100% owned by Swedish Holmen. The

purpose of this company is to provide raw material for its mother company in Sweden. As a consequence, Holmen in Estonia is only a purchase company and accordingly not a trading company. The whole idea with this company is to supply the company in Sweden with wood. The company is totally dependent on Holmen in Sweden and the way this company develops, and there is therefore, no long-term future potential for this company in Estonia. The company's work is focused on logistics, working at the ports with shipping and loading pulpwood. The reason for this strategy is that Estonia has no major pulp mill yet. "*So we know that all the pulp must eventually reach the ports one day, so we just sit there and wait trying to be competitive on the prices on service for their customers*" (Tanel Tuuleveski, Managing Director).

6.7 PORT OF TALLINN

The Port of Tallinn competes fiercely for the Russian transit cargo with the other ports in the Baltic region. Accordingly, investments are the key to further growth and a five-year plan for investments is planned. The Port of Tallinn actually consists of four ports: Muuga, Old City, Paljassaare and Paldiski South. The Muuga port is the largest and deepest port as well as the center of the transit trade from Russia. It is also one of the most modern ports in this part of the world. The harbor is located 17 kilometers east from Tallinn and the loading, discharging and storing of oil and oil products, grain, fertilizers, containers, cargo, timber and other bulk is possible. Due to its beneficial location and good rail and road connections, the Muuga Harbor handles almost 90% of the transit traffic going though Estonia as well as around 70% of the Port of Tallinn's total cargo traffic.

Regarding the three other ports, Old Town is the perfect harbor for passenger ferries, whereas the Palassaare Port is a cargo port, handling mainly mixed cargo, coal and oil products but also timber and perishables. Finally, the Paldiski South Harbor, which is located around 59 kilometers west of Tallinn, is the newest member of the Port of Tallinn. It handles metal scrap, fertilizers, timber, peat and cargo.

7. EMPIRICAL FINDINGS AND ANALYSIS

To increase the transparency of this research the choice has been to combine the empirical findings with a more extensive analysis. Accordingly, the empirical findings are firstly descriptively presented to facilitate the general understanding. Secondly, since the field study was conducted in Estonia, the analysis is subsequently based on a more specific discussion of relevant factors that could have an influence on especially the Estonian trade development.

7.1 DETERMINANTS OF FUTURE GROWTH OF FOREIGN TRADE IN ESTONIA

The identification and selection of determinants influencing foreign trade growth has been based on the consideration of a number of factors. These factors are a result of the author's evaluation of theory and prognosis as well as the outcome of the discussions during interviews. This chapter will evaluate these factors considering their impact on the further development of foreign trade in Estonia aiming at receiving an indication that will be as credible and fair as possible for the short-term development of foreign trade. The factors chosen include economical factors such as the global economical recession, a membership of the European Union, the development of trade with Russia, foreign direct investments, the industry structure and the developments of Latvia and Lithuania.

7.1.1. ECONOMIC FACTORS

A country's internal economical situation affects its foreign trade balance. In an economical recession, it seems natural that a country's trade would be negatively affected resulting in diminishing exports (due to a decrease of foreign demand). On the other hand, an external economic recession may also, to a certain extent, determine the internal economy through its foreign trade. If there is a recession in the telecom industry, this negatively influences the

exports of for example Sweden and this, in turn, has a negative impact on the economy. The conclusion is that the economy and foreign trade are strongly connected. Accordingly, this part of the thesis begins with a summary of the current economical situation in Estonia, continuing with a discussion around some other factors that may have an impact on foreign trade.

7.1.1.1 Current Economical Situation

Despite the current world recession, Estonia still has a substantial economic growth rate, predicted by the Estonian Ministry of Finance to reach 4,8% in 2001 and thus, Estonia is one of the fastest growing economies in Europe. However, it would be wrong to say that the world recession has had no impact on Estonia. Compared to last year, when the growth was 6,9%, it is evident that economic growth has slowed down. It is obvious that growth expectations have gradually diminished throughout the year. The European Commission did for example (as did other predicting organizations) predict an economic growth of close to 6 % as late as during the spring of 2001. Economic growth and development in Estonia is highly dependent on exports and foreign direct investments due to the small domestic demand. In fact, exports make up 64% of GDP. (www.investinestonia.com) However, the fact that domestic demand that is, the increase of consumer spending and investments, has grown to be an increasingly important source of economic growth in Estonia during the last couple of years, and considering the unstable external environment, economic growth will most certainly continue to be based to a large extent on domestic demand in the near future. However, due to its small domestic market export growth will continue to play a vital part of the country's development. (www.ee/epbe/)

The effects of a global economic recession are most visible in the growth of foreign trade. As a direct result of the slowdown, foreign trade growth has decreased substantially during the last few months. Due to the decrease in foreign demand, the growth rates of the manufacturing industry are significantly lower compared to last year. Machinery and equipment, which includes electronics, is clearly the most affected sector of industry since it is more open to shocks in external demand. In fact, if it were not for the electronic industry, the real growth of exports would have been much higher. Hence, the

decrease in export growth is mainly a result of the decrease of mobile phones related subcontracting and cannot be considered as a sign of decline in the Estonian industry. (www.fin.ee/) The high-technology sector has recently been one of the most dynamic parts of Estonia's industry, however it constitutes only a few percent of total industry sales. The conclusion is therefore that more traditional branches of industry, as the machinery and textile industries will compensate for a great part of the reduction based on a weaker global demand. Thus, the Estonian economy and industry as such is not entirely dependent on the telecommunication sector although the exports naturally are greatly affected. (www.seb.se) Nevertheless, the forecast for the second half of 2001, predicts an overall slower growth as a result of the open Estonian economy. (www.fin.ee/)

During the first half of 2001, there was a fast growth of consumer prices. This was mainly a consequence of external factors such as an increase of meat prices, which was a result of the animal epidemics and the following limitation of European imports of meat, an increase of fuel prices, the appreciation of the dollar as well as the increase in personal purchasing power. Accordingly, the inflation rate has increased compared to last year and is estimated at 5,8% for the year 2001. (www.ee/epbe/) The investment growth has so far been impressive for this year compared to previous years. The growth is mainly explained by the continuing restructuring and the expansion of production capacity. (www.fin.ee/) Further, unemployment is a continuing problem that the government must try and solve; the unemployment rate of around 13% is not predicted to decrease much in the near future. The current simultaneous steady growth of both wages and unemployment signifies that there is a great demand for qualified labor, which indicates that unemployment continues to be structural. (www.ee/epbe/) Estonia has continuing problems with regional differences with the northern part being mainly industrial and the south mainly agricultural. This is to a large extent a consequence of the major concentration of FDI (90%) in the surroundings of Tallinn, which has kept the southern parts of the country and the countryside rather undeveloped, and where unemployment is high but the education level and wages are low. (Raie, Estonian Chamber of Commerce and Industry)

Table 1 Main macroeconomic indicators for the years 2000–2005

	2000	2001[1)]	2002[1)]	2003[1)]	2004[1)]	2005[1)]
GDP, billion kroons	**85.4**	**93.9**	**101.9**	**111.6**	**122.1**	**133.5**
GDP, real growth, %	**6.9**	**4.8**	**5.0**	**6.0**	**6.0**	**6.0**
GDP deflator, %	**4.7**	**4.8**	**3.4**	**3.3**	**3.2**	**3.1**
Real growth of investments, %	**2.0**	**5.9**	**9.6**	**8.5**	**8.0**	**8.0**
Real growth of consumer spending, %	**8.2**	**6.1**	**7.5**	**5.5**	**5.4**	**5.4**
Real growth of goods and services exports, %	**30.7**	**-1.0**	**4.0**	**10.1**	**7.9**	**7.9**
Real growth of goods and services imports, %	**29.0**	**11.6**	**5.4**	**10.8**	**8.1**	**7.7**
Current account balance, % of GDP	**-6.4**	**-7.2**	**-6.9**	**-6.6**	**-6.1**	**-5.3**
Growth of consumer prices, %	**4.0**	**5.8**	**3.8**	**3.5**	**3.5**	**3.5**
Employed, in thousands	**608.6**	**608.9**	**610.8**	**616.0**	**621.0**	**626.0**
Unemployment rate, % (by ILO methodology)	**13.7**	**13.4**	**13.4**	**13.1**	**12.7**	**12.3**
Real growth of salaries, %	**6.3**	**5.4**	**4.8**	**4.4**	**4.2**	**4.2**
Real growth of output by employed, %	**7.8**	**4.8**	**4.7**	**5.2**	**5.2**	**5.2**
Domestic savings, % of GDP	**18.3**	**18.1**	**18.5**	**19.3**	**20.1**	**21.4**
General government revenues, % of GDP [2)]	**36.0**	**35.8**	**35.7**	**35.3**	**35.3**	**35.2**
General government expenditure, % of GDP [2)]	**36.7**	**36.0**	**36.0**	**35.8**	**35.5**	**35.2**
General government deficit/surplus, % of GDP[2)]	**-0.7**	**-0.2**	**-0.3**	**-0.5**	**-0.2**	**0.0**

Sources: Statistical Office of Estonia, Bank of Estonia, Ministry of Finance.

1) Forecast of Ministry of Finance.

2) Including the impact of pension reform and impact of introducing unemployment insurance scheme.

7.1.1.2 World economy

At present, there is no doubt that the future world economy is characterized by high uncertainty. The world recession, which began in the second half of 2000, and has had a large impact on other regions except for the leading economies of United States and Japan, shows no indications of improvement. Obviously, the ongoing war against terrorism acts as a contributing actor to worsen the situation and to postpone the recovery of the economy. As a small economy, Estonia is highly affected by disturbances in the external environment and will be increasingly more affected as its trade develops. Consequently, the slowdown of the global economy is one of the major factors that must be taken into consideration when predicting economic growth. However, since the link with the U.S. economy is still quite undeveloped and thus relatively weak, negative trends generally reach Estonia indirectly through its main European trading partners. Accordingly, the expected economic slowdown in Finland and

Sweden is a threat to exports since it is highly dependent on the conditions of these economies and above all by the situation in the telecommunications market. *"The things that affect the main trading partners of Estonia also affect Estonia. That is, what affects Sweden affects Estonia. So indirectly a stagnating world economy also affects Estonia since it affects Estonia's main trading partners"* (Nirgi, Estonian Trade Promotion Agency).

On the other hand, both Madis Mädamürk at AS Tarkon and Gunnar Wissing at Flexa Esti AS indicate that Estonia might gain from a prolonged economic crisis.

"*If there will be a major world recession, I believe that Estonia will win from that recession. We have a lot of possibilities to new partners, new jobs and new businesses, it is only a question of how much we can handle. In the next 5 years I see a big increase here both in the industrial sector and in technology. Because when Sweden is affected by the world crisis, their companies will start to look for cheaper places to produce and move their production to for example Estonia*" (Mädamürk, AS Tarkon).

"*First of all Estonia is a small growing economy, the growth rate may drop a bit but still the growth will remain and it will be considerably higher than in many other countries. The fact that it is very cheap to produce in Estonia makes it profitable to increase production in Estonia even though we will experience a world crisis*" (Wissing, Flexa Esti AS).

The possible gains would certainly to a large extent be connected to subcontracting since the main incentive for foreign companies would be to lower costs through locating their production facilities in countries like Estonia where production costs could be substantially lowered. Thus, any longer term gains are much more insecure. Clearly, any gains Estonia might receive from the world recession will depend on the nature, length and seriousness of the crisis.

Authors' Remarks

In the near future, the growth of exports and imports will remain moderate as a result of the unstable external environment. The increasing domestic demand together with the high investment demand will lead to a more rapid growth for imports than for exports. Due to the increase of export prices, the growth of exports will probably remain negative for the whole of 2001. (www.ee/epbe/)

However, in a longer time perspective (five years), Estonia is of course dependent on the outcome of the world recession. The question is how great Estonia's opportunities to gain from this crisis really are. It is of course, impossible to predict the extent of any word crisis and its impact on individual countries. Yet, there is always the possibility for assumptions. Assuming that the crisis will be prolonged, seriously injuring the US economy, the risk is impending that it will continue to negatively affect Europe as well. Accordingly, Estonia's main trading partners will most likely be forced to continue diminishing their costs, which certainly could result in the increase of foreign investments in Estonia. However, there is also the possibility that companies will seek even cheaper production places in Estonia's neighboring countries or even in Asia. Additionally, concerning more distant trading partners like the United Kingdom and the United States, it could certainly seem somewhat farfetched to assume that companies in these markets locate their production in the Eastern Europe instead of Asia if the aim is not to reach the Russian market. The question is what will be more important, the close location together with lower costs or the substantial lowering of costs together with a much more distant location? On the other hand, assuming that the world recession will be short, Estonia has every opportunity to continue growing at a high rate with only a slight reduction of growth in comparison to recent growth rates.

So far, Estonia's foreign trade has been affected and the economic growth rates have dropped. It is of course essential to point out that the economic growth rates still significantly exceed the rest of Europe. However, assuming that the GDP growth rates will stay around 4-5 percent (or even lower) during the next five years or so as a result of a world recession, it will obviously postpone Estonia's foreign trade development and it will take longer to reach the levels

comparable with a Western country. On the other hand, there is a chance that the foreign trade will increase rapidly as a consequence of enhanced subcontracting, which could actually boost the development.

The question is if Estonia will gain from this in the long run. To grow further and be able to take the next step in its development, it seems obvious that Estonia needs more developed product manufacturing in its key industries. Clearly, Estonia cannot stay a low-cost production site for all eternity. Being so focused on subcontracting may delay and complicate the development of Estonia's own industries. Of course, Estonia must take the opportunity to learn and grow through subcontracting. However, it is important to achieve the correct balance in doing so.

7.1.2 THE EUROPEAN UNION

A future membership of the European Union would undoubtedly result in a number of consequences for the development of trade in Estonia and opinions are divided as to whether the result will be positive or negative for Estonia. Carl-Henrik Andersson at the Swedish Trade Council see two possible opportunities for such a small country as Estonia. They either become a member of the EU or they choose to stay outside the collaboration and thus, indirectly align with Belarus and Ukraine. It seems as if Estonia has already made this choice. The government's work has to a large extent been focused on a future EU membership and prepared the country for this. Estonia already has free trade with the EU. (Andersson, Swedish Trade Council)

Avo Kaasik at the Port of Tallinn sees a membership as Estonia's only opportunity for further development. Estonia will not survive outside the EU, it is not as strong as Norway or Switzerland. Kaasik sees much future potential for the Estonia's foreign trade within the borders of the EU. Estonia will be able to further benefit from its geographical position between Russia and Europe, as Estonia will be able to attract more companies establishing here. Companies would use the advantage of the Estonian location and lower costs to invest in Russia and would still be able to remain on EU soil. When more countries outside Scandinavia were to invest here, Estonia would be less

dependent on the developments in the Nordic countries. Accordingly, these establishments would substantially increase the Estonian export. (Kaasik, Port of Tallinn) If Estonia becomes a EU-member, Russia would be forced to drop its double tariffs and trade will be enhanced. A EU membership would also contribute to a stable economic environment and the financial credibility would be raised. (Raie, Estonian Chamber of Commerce and Industry)

Yet, there are other opinions that the EU will have no impact on foreign trade whatsoever since Estonia already has a free trade agreement with the EU.

"*I don't see how the EU could affect our company since we today already try to live in compliance with the demands of the EU. I don't think the export would be affected either, to my knowledge there are no tariffs or restrictions affecting trade at present. I am not even sure that Estonia will join the EU. The attitude among citizens is fluctuating violently*" (Wissing, Flexa Esti AS).

"*Maybe, the EU membership will increase the country's credibility and thereof promote trade. However, I feel that Estonia has been successful in that respect anyway. In the long-term it could be advantageous, but that depends on the development in the rest of Europe. It could conversely be more advantageous to not be a part of the EU, since investors could avoid the bureaucracy with the Union and still be in the center of Europe*" (Sirkel, Baltex 2000).

Additionally, there are also a number of other negative factors and question marks with a membership. Mati Sirkel recognizes few advantages with the possible EU membership. His opinion is that the costs and the taxes will increase which will put the country in debt. Gunnar Wissing at Flexa expresses the disadvantages for the Estonian population in general. "*The EU membership will be good for the country in general, I'm sure, but on the other hand it will be more expensive for the individual people. The taxes will increase, the wages will of course increase, and then we will get high inflation (already today Estonia has twice the inflation compared to most western countries) because then companies will like to have more for their goods*" (Wissing, Flexa Esti AS).

There is a general fear that higher labor costs and standards of living will eventually end Estonia's role as a subcontractor, and the question is how much this will affect Estonia. Further, the free labor movement can result in a severe loss of human know-how. Some companies may also be unable to sell its products to the EU since the quality level will be too low. It is therefore imperative for companies to invest in quality immediately. (Vahter, Estonian Investment Agency)

According to Madis Mädamürk at AS Tarkon, there are both advantages and disadvantages connected to the possible membership of the EU. There are fears that the EU membership will increase costs of production, and cause a less attractive market for investment into the country and while the price level increases then the company's products will have to compete on a whole new level. On the other hand the opening of the labor market is positive and probably the standards of the whole country will rise. Therefore, Mädamürk believes that Estonia will loose from the EU membership in a short-term perspective but win something back in a long-term perspective.

Authors' Remarks

To a large extent the advocates and opponents of a membership of the European Union in Estonia reflect the same fears and opportunities as any other Western country about to become a EU-member. However, since Estonia is a country in transition, the preconditions differ somewhat. Being a low-cost alternative for foreign companies today, Estonia fears the loss of its subcontracting role with the increased wages and overall living standards. It is only natural for such a country to fear its future development and the external factors influencing it. It is certainly true, that in the case of a EU-membership, Estonia will eventually loose its current advantages.

On the other hand, there are several opportunities with the EU. The increased living standards will gradually move Estonia forward in its development, leaving new possibilities for the further growth of foreign trade. As a result, Estonia may loose in the short term but will most likely gain in the long run. The general feeling is that Estonia does not have much of a choice but to join. Standing outside the alignment of the European countries will not be easy,

especially not for a country such as Estonia. It is naturally impossible to know the outcome of the European Union. Yet, since Estonia's main trading partners are in Europe today, it certainly seems risky to stay outside. Of course, the development is highly dependent on when the EU will accept Estonia as a member. The situation may seem totally different in five years, if Estonia has not been accepted by then. The European Union has admittedly set the admission date in three or four years, but there are certainly no guaranties for this and it depends on the capabilities of the European Union to accept further members in such a short period of time.

7.1.3 THE DEVELOPMENT OF TRADE WITH RUSSIA

The general opinion of the respondents seem to be that Estonia is not as affected by the United States as it is of Russia, mainly since the link with the United States is still quite undeveloped and thus relatively weak. According to Mati Sirkel, Estonia is directly much more affected by the developments in Russia and Avo Kaasik has basically the same opinion. *"Since Estonia is such a small market, it is very dependant on the developments in either Russia or Europe"* (Kaasik, Port of Tallinn).

Today a quite large share of the Estonian foreign exports are transited trade from Russia even though a large share of this trade can be accounted as raw materials, especially fuels and metals. In addition, a considerably larger share then is shown by the statistics is exported from Estonia to Russia, since the Russian tariffs have forced Estonian goods to make a detour through Finland. With consideration to the geographical location and long historical links it could be an advantage for the Baltic countries to increasingly align with Russia. However, this is highly dependant on the political and economical development in Russia. "*The Estonian economy will gain much if or when the economic development in Russia turns to the better. There is a huge export potential in the Russian market. Today, the high taxes and tariffs makes the Estonian products uncompetitive in the market, since even German products often are cheaper. But when Russia becomes a member of the WTO the tariffs must be dropped"* (Sirkel, Baltex 2000).

Today, the expectations seem to be that the relationship with Russia will grow stronger and bring positive results in the future. It is anticipated that the trade barriers, which Russia has put up against the Baltic countries, must be dropped when the country becomes a member of the WTO. "*For the future I would like to see a closer relationship to Russia. Today Estonia is restricted by many customs regulations which makes it is very difficult to do business in Russia"* (Madis Mädamürk, Tarkon). Also, the Port of Tallinn, similar to other ports in the Baltic countries, expands dramatically and these investments are based on expected continued and escalating transit trade from Russia within the forthcoming years (Kaasik, Port of Tallinn).

Authors' Remarks

The implications for Estonian foreign trade are today really hard to predict, because it is somewhat linked to the development in Russia. Judging from the present situation there are still too many question marks about the Russian economy to make a relatively sure prediction about the possibilities of sustainable growth within five years. Nevertheless, the possibility that Estonian foreign trade might focus on Russia to an even greater extent in the future should be taken into account. According to SEB's Baltic Outlook (2001), it is likely that the EU's share of trade will gradually decrease during the coming years simultaneously with a growth of trade with previous USSR countries. For the small markets in the Baltics and the closeness to the Russian market the gains of Russian trade are simply too extensive to ignore. Actually, according to the conducted interviews it is most likely that the Estonian trade with Russia will increase especially when Russia drops its trade barriers.

7.1.4 FOREIGN DIRECT INVESTMENT

Foreign direct investment has played a major part of the development of Estonia. First of all, it has brought valuable know-how in management and marketing into companies, which has increased efficiency and productivity to a large extent. FDI have further promoted economic growth and created jobs. The former state owned company AS Tarkon acknowledges the importance of FDI for the company's acclimatization to a market-driven economy. "*The state owned company Tarkon could only manufacture products, back then we knew*

nothing about how to market and sell a product to customers. Therefore we would not have survived without the knowledge input from the Swedish company Hallberg Sekrom. By connecting existing knowledge and customers from Hallberg Sekrom and experience of multifaceted manufacturing from Tarkon, it became possible to realize the vision of a competent and complete system supplier" (Mädamürk, AS Tarkon).

At the end of 2000, the FDI stock per capita was 2039 Million USD, which is the second highest among Central and Eastern European countries after the Czech Republic. This year is predicted to be a new record year of FDI inflow. (www.investinestonia.com) Sweden is the largest investor in Estonia, holding 37,6% of the total investments. Finland has 28,8%, the Netherlands 5,7% and the U.S. 5%. The investments are divided relatively even within the banking and transport/communication sector. (www.swedishtrade.se)

The main reasons why foreign companies invest in Estonia are the result of several factors including low production costs (low costs for labor and raw material), favorable location, a stable and liberal economic environment, a well-developed telecommunication network as well as a highly skilled workforce. Both the interviewed companies and organizations mention low labor costs as one of the most important motives behind foreign investments into Estonia. The explanation for this might be that the Estonian market of today is rather limited due to its small population and low-income levels. However, they also agree that the low labor cost factor will increasingly loose its importance, although Estonia will continue to offer generally lower production costs than other European countries for quite some time to come. The reason for this conclusion is that it is expected that the Estonian wages will increase, especially when Estonia becomes a member of the EU. Therefore, this factor is primarily seen as a short-term factor. *"Today, many companies still consider Estonia to be a low-cost country and we will be able to attract investments due to this advantage for another ten years or so. But in ten years time, when we are members of the EU, our salaries will increase and then we have to rethink our strategy. Because then we cannot rely on "our cheap hands" for production, but we also have to use our brains to be competitive"* (Mädamürk, Tarkon).

Accordingly, low labor costs are not considered a sufficient reason to move the production to Estonia, and therefore should not perform the main basis for long-term strategic investment decisions. Hence, there must be another prime motivator for firms to engage in such investments.

The theoretical framework implies that the primary motive for investments into a transition country is size, opportunity and long-term growth potential of the market. Certainly, the Estonia market is no exception. In a study conducted by Nieminen and Törnross in 1997 (Golubeva, 2001) the primary motive for the attraction of Finnish firms to Estonia is the new emerging market. The Estonian transition has been truly successful and today the growth rate of the country is among the fastest of the CEEC. Even though the Estonian market separately may be considered small, the Baltic countries together constitute a noteworthy market with the potential of being quite flourishing with a long-term perspective. It can also be assumed that foreign investors are seeking the market opportunities of Russia through establishment in Estonia. The population of the Baltic countries has inherited knowledge of the Russian language and business culture and therefore these markets constitute a gateway to the Russian market. When the Russian market is opened up, companies established in the Baltics have an excellent opportunity both to establish new businesses within the Russian market or conduct trade through exports and imports with the vast emerging market.

As Swedish Trade Commissioner Carl-Henrik Andersson puts it: "*One of the reasons for investing here is the intention of entering the Russian market in the future. This market is still very inaccessible for foreign investors and many count on obvious benefits/advantages of being located in Estonia first*." However, Priit Vahter at the Estonian Investment Agency argues: "*To be able to take more advantage of being close to Russia, the income levels of the Russian people will have to grow and this will take some time*." Finally, Andersson also argues that: "*the closeness to the Western world and to Europe makes it easier to control. It would probably be cheaper to place the production unit in Asia, but that is so far away*."

The case companies also emphasize the future importance of Russia. "*The geographical location next to the market in Russia with its future potential is an important reason for investments into Estonia"* (Sirkel, Baltex 2000).

"There will probably be more and more investment coming to Estonia. The old connection to Russia will be an advantage for Estonia, because of the knowledge of the Russian language and business culture. In addition old traditional trade routes to Russia could still be used" (Wissing, Flexa Esti AS).

Besides the potential of the Russian market as such, the company AS Tarkon also believes that the production costs in Russia will be lower than in Estonia in the future. "*In 10 years Tarkon might have to move the production to Russia to keep the costs down, but we must also take advantage of the knowledge that we have about Russian language and culture. We could for example help Swedish and Finnish companies to set up their production in Russia"* (Mädamürk, AS Tarkon).

The countries that have predominantly invested into Estonia seem to have links to the market in terms of history, culture and geographical proximity. Estonia has for example, in different periods of time, been under the ruling or influence of Swedish, Danish and German kings. According to Madis Mädamürk traces of these cultures are still found in the Estonian culture and that is one of the explanations to why Sweden, Denmark and Germany are among the dominating investors in Estonia. "*Therefore, we are more alike and it is easier to do business here than in for example India, even if India have even cheaper labor*" (Mädarmürk, AS Tarkon).

According to the Uppsala school the procedure of foreign direct investment starts with exports, gradually continuing with an agent, joint venture and finally Greenfield investment. According to Priit Vahter (Estonian Investment Agency), Estonia is no exception in this sense. However, many companies were sold to foreign investors during privatization, whereby many foreigners directly entered the Estonian market through acquisition. Since privatization is soon completed, Greenfield investment is rapidly becoming the main focus of FDI. (Juurikkala, 2001) Therefore, it appears that the procedure of investments

in Estonia is a bit different than suggested by the Uppsala approach. The explanation for this development might be that the most common purpose behind investments in Estonia is based on production/subcontracting and accordingly not investments for the internal market. This is especially true for the machinery and equipment sector. Consequently, there is no point in following a step-wise process and acquiring knowledge about the market, since it is not the internal demands that are pursued.

Authors' Remarks

Foreign direct investments are clearly an important part of the Baltic states transition from a centrally planned to a market-driven economy. The market knowledge and capital that FDI have brought into Estonia, Latvia and Lithuania, has indirectly supported the development of and generated foreign trade. There is often a correlation between the origin of investments and foreign trade, meaning that an important investment country most often also is an important trading partner. However, this linkage depends on the motives behind the investment. Market-seeking foreign investments targets the market itself and might therefore not contribute as much to the foreign trade of that market. On the other hand, production-oriented motives usually result in that the production is exported back to another market. Thus, the direct effect of the investment is an increase of foreign trade.

The reasons or motives for the investments however seem to change at the same pace as the transition of the country. Low labor costs are recognized as an important but a short-term advantage. This advantage has derived production facilities and accordingly subcontracting to Estonia. However, subcontracting cannot be considered as beneficial for the country in the long-term since it creates too little value-added within the country and therefore little value through exports. The future and more long-term advantage in Estonia is, besides the potential of the own market, the geographical location next to the big market in the East and the opportunities this market could bring for foreign investors in Estonian. However, it is also expected that the investments in an increasing degree will invest in full-scale production facilities in Estonia. This will increase the added value of the production within the market and consequently deliver more value for the exports of goods.

7.1.5 INDUSTRY STRUCTURE

7.1.5.1 The Machinery and Equipment Industry

Owing to electronic equipment, which is the largest part in this sector, the machinery and equipment sector accounted for 37,4% of the total exports in 2000. The electronic sector is highly dependent on subcontracting (more than 80% of the exports are derived from subcontracting), where many parts are assembled in Estonia and further exported. One company alone is especially essential for this sector, Elqotec, which is a subcontractor for Nokia and Ericsson. Elqotec accounted for 25% of total exports in Estonia in 2000, which makes it the largest exporting company in Estonia. However, due to the recent great recession in the telecommunication sector, Ericsson has actually withdrawn its contracts with Elqotec and Elqotec's importance in Estonia's exports has already, and will consequently continue, to diminish substantially. The drawback of Elqotec has generated a fear for the Estonian economy as a whole. However, as was mentioned earlier the high-technology sector only constitutes for around 5% of total industry sales. Therefore, there is reason to believe that other branches of industry can compensate for a great part of this reduction.

So far, there has been most increase and potential in the machinery and equipment industry sector. However, most of the organizations and companies interviewed seem to see less potential here in the future. The reason for this acknowledgement is partly that this sector is largely dependent on subcontracting where not much value is added, *"Elqotec is just an assembly company, a subcontractor, not much value is added here"* (Raie, Chamber of Commerce). Furthermore, Avo Kaasik, the Port of Tallinn thinks that Estonia's future as a subcontractor is limited due to the fast development of technology and increasing production costs. This will change the Estonian trade and other manufacturing sectors will be much more important in the future. This process will enhance if Estonia becomes a member of the EU in the near future. However, there has been an amazing development in IT and telecom in Estonia and the future potential is large. Therefore, the machinery and equipment sector as a whole still has a substantial amount of potential for the future.

"*I see large growth in this sector of telecommunication industry in Estonia, and therefore I also expect increases in exports. For example, 30 suppliers in the car industry will soon be coming to Estonia to look for partners. Volvo has encouraged their suppliers to move production to Estonia, if they cannot manage to cut costs in Sweden. Now also the German car industry is coming to Estonia*" (Mädamürk, AS Tarkon).

7.1.5.2 The Wood Industry

There are two basic kinds of wood industry, the sawmill and the pulp and paper industry. At the beginning of the 1990's when foreign trade was liberalized, almost all the raw material coming from the forest were directly exported because there were no large saw mills nor pulp mills in the country. Nowadays however, the sawmill industry has developed and almost no raw material is directly exported without added value. Yet, around 90% of the raw material in the pulp and paper industry is still directly exported due to the absence of pulp mills. Therefore, a substantial part of the exports are still raw materials and there is still great potential for further development in the production of basic manufactured goods and finished manufactured products, which will bring more money into Estonia. (Tuuleveski, Holmen Mets) *"The more production and processing of the wood that is done here in Estonia, the more value the exports will generate"* (Wissing, Flexa Esti AS).

The saw milling industry is becoming an increasingly essential part of foreign trade. Tanel Tuuleveski, Managing Director at Holmen Mets, sees a great deal of future potential in this sector as more and more saw timber will be value-added in the future. (Tuuleveski, Holmen Mets) Estonia is also known for its log houses, which is a growing industry in Europe as well. However, Estonia does not yet possess the right to build any log houses in Europe and can therefore not provide this service there. (Nirgi, Estonian Trade Promotion Agency) At 13,4%, wood and wood products accounted for the second largest share of exports after machinery and equipment in 2000. (www.investinestonia.com) The forest industry is also one of the few industries in Estonia with a positive trade balance, approximately 5-6 times more is exported than imported. (Tuuleveski, Holmen Mets)

7.1.5.3 The Textile Industry

The textile industry is traditionally an important sector in Estonia, accounting for 11,3% of the exports in 2000. This makes it the third largest export sector in Estonia. The textile sector is somewhat affected by its largest player, Krenholm, which is much larger and broader than all the other companies. Being one of the oldest industry sectors in Estonia, textile will hardly disappear although companies will be forced to specialize in the future to be able to survive. The textile industry in Europe has been largely obliterated by the increasing competition from the Far East, which is one of the greatest challenges for the European modern textile industry. This has made it necessary for the weaving companies in Germany, France and the United Kingdom to become technologically very advanced and find new segments with very specific products. This is naturally affecting East Europe and Estonia as well since they follow a similar path of development. "*We have the same problems as the textile industry in Germany, France and United Kingdom had ten or fifteen years ago. We are aware that we also have to become more technologically advanced and produce highly specialized and value-added products to meet the increasing competition from the Far East producers*" (Sirkel, Baltex 2000). As a result, it will be increasingly important to increase quality and focus on niche products and markets. Mati Sirkel at Baltex 2000 sees the next few years as critical to the development of this industry sector.

Anatoly Ilkevich (Krenholm) emphasizes Estonia's strategic location as the main influencing factor for further growth and considers the Far East and countries like Pakistan or India as minor competitors in the near future. *"Consumers of textile goods prefer to source their products from alternative sources today. Those who are importing goods from Pakistan or India are today looking for secondary sources that are more reliable and stable"* (Ilkevich, Krenholm). However, one explanation for the differences in opinion between Baltex and Krenholm are reflected in the differences in production. While Baltex relies on the production of raw materials or semi-manufactured products, Krenholm has much more high quality refined products, which accordingly do not directly compete with the manufacturers of the Far East.

Mati Sirkel (Baltex 2000) believes that the production of textiles will increasingly move to Eastern Europe, because it is a rather labor intensive industry and the labor costs will continue to be much lower here than in Western Europe for another teen years. Further, Estonia's advantages are its location, being much closer to the western markets than the Asian producers are, the quality and special conditions such as offering open credits. In Anatoly Ilkevich's opinion, the main benefit with investing and producing in Estonia for a foreign business is first of all the economical benefits of a low cost production. Additionally, the Estonian workforce has a great deal of technical knowledge of textile production. Traditionally, the Narva area has a long tradition of textile production and "people here know what they are doing". Therefore, it makes great sense to invest here. Siim Raie (Estonian Chamber of Commerce) recognizes a great deal of potential in the textile sector, where the growth will mainly come from the development of domestic brands, something which already has been quite successful today.

7.1.5.4 The Development of the Transportation Sector

Besides these three sectors, metals and transport and logistics are of significance in Estonia. Especially the transportation sector has expectations for the future with the further development of transit trade with Russia. The Estonian ports play an essential role in this development and compete with Latvia and Lithuania over the position as the "hub" for the trade with containers to large ports in Europe. The transit trade is already a vital part of Estonian trade and the potential for the growth of trade in general with Russia is immense, especially as Russia will be forced to drop its current double tariffs against Estonia when Estonia enters the EU.

The major means of international transportation are ocean transportation and air carriers. Thus, the ports in Estonia play a major role in the development of foreign trade and transportation of the country. Due to its location and the nature of exported products, ocean transportation is a commonly used transportation method and the transportation sector plays an increasingly important part of the Estonian economy. The further development of the transportation sector and of the ports will undoubtedly enhance foreign trade in

Estonia as foreign trade naturally depends on low transportation costs and efficiency.

Authors' Remarks

It is evident that the further growth and development of major industry sectors greatly depends on the success of Estonian manufacturers to increasingly process its products. Even though Estonia may remain a low cost opportunity for foreign companies for quite some time to come, the time as a low cost choice is still limited. Estonian manufacturers need to utilize its short-term future as a subcontractor, although simultaneously concentrating on improving its comparative strengths. The danger to trust its low cost production without developing the quality, efficiency and know-how is impending. The foreign trade development is highly dependent on this understanding. The knowledge and quality of Estonian enterprises must in connection with slightly lower costs and prices oust competitors in other parts of the world in order to survive.

It is important that Estonia focus its resources in the industry sectors where it has an advantage or at least where there is potential to develop an advantage. Exporting is generally dependent on an excess of something. Accordingly, wood, textile and IT are undoubtedly essential industry sectors with large future potential and where foreign trade has an opportunity to grow. Estonia's foreign trade is naturally depending on its success of developments in its key industry sectors.

7.1.6 THE DEVELOPMENT OF LATVIA AND LITHUANIA

The general opinion is that the Baltic region will be much more even within a few years. The question is what will happen when Estonia's neighbors have caught up and how their development will influence the further trade development in Estonia? Latvia's economic growth has so far been amazing for this year (2001) and many people think that Riga has the location and potential of becoming the future economical and international center in the Baltics. Latvia is generally considered to be the closest to catch up with Estonia. Mati Sirkel (Baltex 2000) thinks that both Latvia and Lithuania will catch up with

Estonia within two years, whereas others disagree claiming that it will take longer, especially for Lithuania.

All countries offer basically the same advantages/disadvantages and products, which to a large extent make them competitors for FDI and exports. The differences regarding industry structure are not very large. All the Baltic countries have production within basically the same sectors: textile, wood, metal, electronic and telecommunication. Further, all the countries depend on transit activities with Russia. Estonia has so far been much more liberal in comparison with its neighbors and have also developed more in technology and IT. (Andersson, Swedish Trade Council)

Latvia's exports grew substantially during the first half of this year. Food, machinery and electronic equipment constituted for most of this increase. However, SEB's Baltic Outlook (www.seb.se) also judges that the improved situation was largely due to an unusually large amount of transit traffic. The extremely positive trend will hardly last and indications already show that declining demand on the German and UK market has affected Latvia. One third of the Latvian exports consist of wood articles that are very sensitive to changes in the business cycles. Additionally, Latvia exports a great deal of less processed products (such as wood and textile) while simultaneously importing highly processed products (such as transport and electronic equipment). This results in a dangerous structural risk in the balance of current payments (between imports and exports). (www.seb.se)

Lithuania's development has been delayed due to a number of reasons such as political instability, a weak domestic demand and a deep recession due to the Russian economic crisis. The recovery has been slow due to a positive export growth while the domestic demand has simultaneously been very weak. This year (2001), the growth has gained speed resulting a considerable growth of exports during the first half year. The growth of exports has been particularly evident in mineral and oil products that constitute one fifth of the export value. Textiles are equally important. However, the growth of exports is bound to diminish due to the negative impact from the recession on Lithuania's two major Western markets Germany and the United Kingdom. It is clear that

Lithuania still lag behind Estonia although they are in the process of gaining ground. (www.seb.se)

Factors that have favored Estonia in its development are the closeness and historic link to the Nordic countries and the greater attraction of tourists, which undoubtedly has brought capital into the country. Potential problems in Latvia could be nationality since almost 40% of the inhabitants are Russians, Belarussians and Ukrainians. According to Nirgi (Estonian Trade Promotion Agency), Latvia still has quite a close connection to the Russian economy. (Vahter, EIA, Nirgi Estonian Trade Promotion Agency) Lithuania on the other hand, remains largely agricultural and less developed than the other countries. Yet, Mati Sirkel (Baltex 2000) still thinks that Lithuania has the greatest potential within the next five years. It has very large industries in textile, machinery and technology, cheaper labor and is a very homogenous society.

Authors' Remarks

The difference between Estonia and its Baltic neighbors is foremost a question of trade and investment, where Estonia clearly is a few steps ahead of the others. Assuming that a prolonged world crisis will gain countries like the Baltics, Latvia and Lithuania seem to have an equally large chance of attracting foreign investments. Since the differences between the countries are diminishing each day, Latvia and Lithuania could certainly have more potential to attract investments than Estonia in terms of cheaper production costs. Some of the interviewed argue that Latvia and Lithuania will gradually take over Estonia's subcontracting role. Regarding the development of ports and transit trade, several respondents coincide on Riga as the Baltic hub of trade and as the international center of the Baltic region. Many factors point to the direct competition between the three countries indicating that Estonia will suffer from the further development of Latvia and Lithuania. Competition can, on the other hand, foster growth and force Estonia to take one step further and in that way enhance Estonia's development. According to Madis Mädamürk at AS Tarkon, Latvia and Lithuania will be part of a more central European trade than Estonia due to its location and history. This could mean that Estonia, Latvia and Lithuania will focus on different trading partners and accordingly that competition will be less direct. Although the situation seems to be more

competitive than cooperative today, there is of course always the possibility that the ties may strengthen in the future and result in a stronger cooperation of trade.

7.1.7 OTHER FACTORS

Another factor contributing to the development of trade in Estonia is the government's future attitude, which does not seem to be an impending problem today. Anatoly Ilkevich at Krenholm does not see any potential problem with the government affecting the export or trade development in a negative way. Estonia has a liberal trade regime and a liberal attitude towards capital movement. Equal rights are granted to foreign and local investors and there are no restrictions for foreigners to own land. (Vahter, EIA) The government has effectively created an incentive for businesses to keep or reinvest their profits back into the business by keeping this tax-free. (Andersson, Swedish Trade Council) Also, oil prices affect all countries although Estonia could be less affected than its neighbors due to its domestic oil shale industry. Further, the currency is another major impact. Since Lithuania's currency is pegged to the US dollar at a fixed rate, this has proved problematic due to the strong dollar rate. Regarding Estonia, it has been vital for its currency to be pegged to the German mark. Estonia's currency has been stable for the last nine years and is generally not considered as posing any threat to the development in Estonia within the next five years.

"*I think that it is very important that the Estonian currency is pegged to the German currency and from January to the Euro. Regardless if Estonia doesn't get into the EU a devaluation of the currency would be if not fatal, very bad and could seriously damage the trust in the economy of the country*" (Wissing, Flexa Esti AS).

8. CONCLUSION

In the conclusions of this thesis an attempt is made to provide answers to the research problems stated in the introduction. Since the field study was conducted in Estonia, the starting point for the conclusions of the second research problem will be from the perspective of Estonia. However, the aim is to provide more general conclusions for the Baltic countries as a whole. A generalization is foremost possible due to the statistical data of the Baltic states which provide a background for further analysis. Additionally, due to the similarity of the countries it is in certain cases possible to transfer the findings regarding Estonia to its neighbors. Finally, in an attempt to answer the main problem, the focus returns to the previous scenarios in Chapter Five and a possible scenario is selected based on the collected information of this study. Conclusions have mainly been drawn regarding the exports to the United Kingdom and the United States, thus, largely disregarding imports from these markets.

8.1 RESEARCH PROBLEM 1

How has foreign trade developed in the Baltic countries since the fall of the Soviet Union in terms of goods and trade partners with special attention to the United Kingdom and the United States?

The development of foreign trade of the Baltic countries has certainly been dramatic during the last decade. Foreign trade prior to independence was totally subordinated the Soviet Union and therefore the Baltic countries started out from scratch. With this in mind, the development has been impressive within such a short period of time. The successful reorientation of trade from East to West has been very important to progress, and today the EU represents the most important trade partner of the Baltic countries. Estonia's most important (western) export partners are Finland and Sweden, while the dominating import partners are Finland and Germany. Latvia's most important Western export

destinations are the United Kingdom and Germany and the main sources of imports are Germany and Finland. Lithuania's most significant Western trade partners, represented both in exports and imports, are Germany and the United Kingdom.

It is obvious that geographical location and history has linked Estonia to Sweden and Finland. The Nordic countries were both early and most aggressive in investing in Estonia. Their investments have boosted the trade development and offer the most noticeable explanation for Sweden and Finland's large shares of foreign trade in Estonia. It is also clear that the United Kingdom and the United States have increased in importance, although only slightly. Latvia and Lithuania seem more focused on Central Europe, which is displayed by their main trading partners Germany and the United Kingdom. This could be a result of their history and location as well. However, it is also noticeable that Finland and Sweden should be counted in as origins of a substantial part of Latvia's imports. Compared with Estonia and Latvia, Lithuania seems to have somewhat closer trade relations with the United States. Even though the United States constitutes a rather marginal trading partner of all three countries, the trade value is still rather impressive with respect to the fact that trade with the United States was close to non-existent in 1993.

Regarding commodities, finished manufacturing and basic manufacturing has been considered the most important categories, since they generate a much higher relative value (compared to raw materials). In the analysis in Chapter Five, the United Kingdom and the United States were regarded as one unity and the compound exports and imports of manufactured goods to and from Estonia, Latvia and Lithuania's were put together. Studying finished manufacturing and basic manufacturing separately, it is obvious that exports are dominated by basic manufacturing although the trend indicates an increasing share of finished manufacturing. This is obviously a result of the Baltic industries gradual development towards an increasingly higher proportion of finished manufactured goods. Imports on the other hand, are dominated by finished manufactures. However, as their exports develop the share of processed goods in imports should diminish. Both the value of exports and imports has gone trough impressive growth rates since 1993 although the

trade value of imports clearly exceeds the trade value of exports between the countries in question, resulting in a quite substantial imbalance of trade in 2000.

8.2 RESEARCH PROBLEM 2

What external and internal factors could influence the further development of the foreign trade within a five-year period?

The factors identified as some of the determinants of the future trade development of the Baltic states are: economical factors, membership of the European Union, foreign direct investments, the development of trade with Russia, the general development of the Baltic countries and industry structure. The focus is here on Estonia, although some general conclusions regarding the whole Baltic region may be drawn.

Estonia

The development has been amazingly fast in Estonia considering its ten years of independence. Thus, a great deal could happen within the next five years. All of the factors discussed in the analysis have a certain impact on the outcome of the Estonian foreign trade. One question mark, which could have an impact on the development of foreign trade, is the extent of the world recession. In a five-year period, Estonia is to a large extent depending on the affects the recession will have on its main trading partners, especially Finland and Sweden. If Finnish and Swedish companies are forced to decrease their trade as a result of an economic recession, Estonia will suffer. On the other hand, if companies choose to locate their production in Estonia as a consequence of a recession, Estonia will gain. Therefore, Estonia is more indirectly than directly affected by the recession.

The outcome of foreign trade is to a certain degree dependent on the extent of the world recession. A prolonged recession could turn out to be an advantage for Estonia, due to its status as a low cost country. However at the same time, a prolonged recession might hold Estonia back in its development, meaning that

the country will be kept as a low cost profile, attracting largely subcontracting investments. In case of a short recession (some experts predict the business cycle to turn next summer), Estonia will probably not be as severely hit as other European countries which gives potential for a fast return to high growth and thus result in only slight reductions of GDP and trade growth. However, in an economical recession the outcome is highly uncertain which makes it extremely difficult to draw any certain conclusions. Anyhow, so far Estonia has experienced an economic slowdown as a consequence of the world recession and only the future can tell if this slowdown is temporary.

If Estonia will become a member of the EU in the next five years, this will of course play a major part in its development. However, the question is how likely it is that the European Union will admit new members within a five-year period regarding the fact that the organization has postponed the admission of new members several times already. The current world recession might also have an impact on the process, especially if the EU members are severely hit by the recession. It is also questionable whether the European Union will admit only one or two of the countries in the Baltic region or whether Estonia will be forced to wait for Latvia and Lithuania to reach an acceptable economic and social level. If EU-membership is to be realized, it is more likely that it will be at the end of this five-year period. Hence, the membership as such will probably not have a profound affect on Estonia within five years but all the more in ten years.

An EU-membership could also result in a stronger trade relationship with Russia as a consequence of the removal of today's double tariffs. Yet, Russia will also have to drop its trade barriers in order to become a member of the WTO, so the question is what comes first. It is evident that some of the respondents in the interviews have high hopes for a stronger trade relationship with Russia. However, Baltic trade relations with Russia can develop in different directions in a five-year period, depending on the general stability in Russia. Thus it is uncertain how important Russia will be as a trading partner of the Baltic countries. In a longer time perspective though, Russia could certainly become increasingly essential. The economical situation in Russia clearly affects Estonia to a certain degree. Consequently, as long as Russia's economy

is very unstable it could constitute a threat, due to its negative affects on Estonia's trade as well as an opportunity for Estonia since foreign companies may avoid investing in Russia and locate in Estonia instead.

Especially at the beginning of the transition period, foreign direct investments (FDI) were important for compensating the lack of domestic capital and for altering the centrally planned system. In addition, FDI has been able to provide modern production technology and infrastructure as well as knowledge of and access to western markets. As a result, FDI has played a significant part in increasing and developing Estonia's foreign trade. Although it will most certainly continue to affect the trade, it seems as if the major impact of FDI has been played out. However, the correlation and links between investment countries and trade partners should still remain, since Estonia has created the closest trade relations with these countries. Some of the other factors will probably have a larger influence on the future trade development. Estonia's foreign trade is of course highly dependent on its success of further developments in its key industry sectors (machinery and equipment, textile and wood). The early and extensive share of foreign direct investments into Estonia facilitated the development of the industry and enhanced exports. However, for the future it is equally important for Estonia to further develop its industry sectors to be able to increase its share of manufactured products, which will increase the value of exports.

The further development of Latvia and Lithuania represent an imposing threat on the Estonian trade, since it will increase competition. So far, Estonia has been relatively successful and unaffected by its neighbors, and it is not until the last couple of years that it has been realized that Latvia and Lithuania could soon compete on equal levels with Estonia. Estonia is thus to a large extent influenced by this development and whether the Baltic countries will be more of competitors rather than cooperators.

Implications for Latvia and Lithuania

Judging from the Baltic countries' similar preconditions, Latvia and Lithuania are equally affected by an economic world recession due to their extensive trade with Germany and the United Kingdom. Both Latvia and Lithuania's

exports are sensitive to changes in the business cycle. For example, more than one third of Latvia's exports are constituted by wood articles that are highly sensitive towards decreased world market prices and a weakened dollar rate. Lithuania will also be negatively affected by the recession in its most important markets, Germany and the United Kingdom. However, assuming that the Baltic countries would gain from a recession, it seems reasonable to believe that Latvia and Lithuania could benefit even more than Estonia. Since Latvia and Lithuania are still not as developed as Estonia they offer somewhat lower production costs. In contrast, assuming that the Baltic countries would be more negatively affected by the world recession, it could be implied that Latvia and Lithuania would be more influenced than Estonia, since they have not reached as far in their overall development. However, so far there are no indications of this statement. As mentioned before it is extremely difficult to draw any particular conclusions on this matter.

Latvia and Lithuania are behind Estonia concerning the EU negotiations, and will most probably not become members within a five-year period. As mentioned before it is possible that the Baltic countries will be accepted as members at the same time, but it is not likely that this will be realized within the next five years mainly due to Lithuania's slower progress of development. Therefore, this cannot be considered as one of the most important factors for the trade development during the relevant time period although it could have a certain impact on the directions of trade. Regarding trade with Russia, the conclusion must be that the same conditions as discussed above could be applied on Latvia and Lithuania.

The influences of FDI are naturally the same on Latvia and Lithuania as in the case of Estonia. Still, the attraction of foreign direct investment has been lagging behind especially in Lithuania. Consequently, foreign direct investments will continue to be essential during the next five years for both Latvia and Lithuania due to rather small domestic market and lacking knowledge. Therefore, foreign trade of Lithuania and Latvia is probably more affected by foreign investments compared with Estonia.

In 2006, the Baltic countries will undoubtedly be on much more equal levels of development, although it is difficult to predict how large the differences will remain and whether Estonia will be in a leading position. The empirical findings suggested for example that the future economic center of the Baltic region would be placed in Riga instead of Tallinn. Due to their similarity, the countries compete to a large extent, which could both foster development while at the same time act as an impediment. It has often been argued that the Baltic countries would gain from a closer cooperation, which could prevent them from competing for the same investment capital and exports. It seems obvious that the countries would gain from better utilizing their resources together instead of competing in the same areas. One example is the development of the Baltic states' ports. It seems ridiculous not to concentrate investments and resources to one location instead of continually developing ports well oversized for their domestic needs, expecting to attract further transit trade to and from Russia. Yet, currently the Baltic countries largely consider each other competitors, making the step towards an increased cooperation quite long.

8.3 MAIN PROBLEM

How large is the foreign trade potential of the Baltic countries in the near future with special attention to trading partners whose location gives most opportunity for reloading goods in Göteborg?

Taking a closer look at the development of the Baltics' total foreign trade during the 1990's based on statistics, the trade seems to follow the most obvious route with regard to the Baltic countries' geographical location. Accordingly, countries surrounding the Baltics are explored first and gradually the circle of trade extends including more distant trading partners. Thus, Estonia's trade with the United Kingdom and especially the United States will not be vital until trade with the currently most essential trading partners Finland and Sweden is saturated. However, the fear of dependency on a few trade partners could on the other hand result in an increased search of new trading partners to spread the risks. This enlargement should, most likely, enhance within the next five years in time with the inevitable increase of total trade. The

question is whether the trade of the Baltic states will take a more southern path, exploring the opportunities of trade with more centrally and southern European trading partners and if this will diminish the possibility of an increased trade with the United Kingdom and the United States in the next five years.

Regarding Estonia, neither the United Kingdom nor the United States constitutes an important share of Estonia's total trade today. Trade with particularly the Northern countries has proved most significant and according to the case companies and trade organizations in Estonia, it seems most likely that trade with these countries will be equally important within five years. In addition, there seems to be more potential with more centrally and southern European countries than with the United Kingdom, and especially the United States in a five-year period. Of the interviewed case companies, it was actually only Krenholm who currently exports a substantial amount of its production to the United States. Generally, the opinion among both companies and organizations was that the United States naturally provides an immense future potential, however in a longer time perspective than five years. The United Kingdom seems more promising although this market has to fight fiercely with, for example, Germany to gain further attention.

However, if the United Kingdom and the United States are considered together as **one** trading partner of the Baltic countries, these markets actually represent a somewhat larger trading partner than, for example, Sweden and are accordingly placed subsequent to USSR, Germany and Finland. Although the composition of trade partners may not change substantially or become western-directed the trade values regarding the United Kingdom and the United States will certainly increase, and could therefore give an opportunity for the Port of Göteborg to participate in this trade. The question is to what extent the value of trade, and especially the value regarding basic manufactures and finished manufactures to these countries, will increase within five years.

One of the factors that can influence the development of trade is the current economic recession. All the Baltic countries are sensitive towards changes in the business cycle, and there is no doubt that the growth rates for at least 2001 will decline. Even though the economies will continue to grow mainly on

stronger domestic demand, exports will certainly suffer from weakened external demand. Estonia, Latvia and Lithuania all export large amounts in industry sectors (mainly wood articles and telecom products) highly affected by an economic recession on world markets. There is obviously a possibility that the Baltic countries may gain investments from the recession that eventually will lead to enhanced exports. However, this largely assumes that the recession will be quite long or that the recovery will be slow, forcing European companies to minimize costs by locating production facilities in for example the Baltic countries.

Another factor that could influence the choice of trading partners and increase the amount of trade to certain markets is a membership of the European Union. Even though a EU-membership was concluded to be quite unrealistic in the next five years, the determination of the Baltic countries to eventually become members could certainly increase the focus on European trading partners. Thus, the negotiations with the EU could enhance the trade with EU-countries including the United Kingdom but on the other hand also with countries like Germany, Italy, France and Spain. Germany is demonstrably the most important Western trading partner of the Baltic countries (especially for Latvia and Lithuania) and there is reason to believe that this relationship could have just as much potential as the one with the United Kingdom and the United States.

Since the United Kingdom is a EU-member and geographically much closer to the Baltic area than the United States, the potential might be higher with the United Kingdom if trade is developed according to geographical proximity. Nevertheless, the vastness and prosperity of the United States' market is naturally an advantage although this market also offers a very complicated and competitive market for such small economies. Further, the economic recession originating in the United States could postpone the development of this trade relationship. A prolonged recession could result in the seeking of alternative trading partners less affected by the economic slowdown. However, as indicated previously, the increase of foreign direct investments originating from the United Kingdom and the United States into the Baltic countries could in contrast certainly strengthen the strings to these countries. Yet, this

assumption seems a little bit farfetched considering the fact that UK and US firms could prefer to locate production sites somewhere else (possibly Asia). This is particularly true for the United States since the distance is obviously considerable to Eastern Europe. Consequently, foreign direct investments originating from especially the United States reasonably aim to enter the Russian market rather than to only obtain lower production costs. Additionally, as has been indicated before a reinforced relationship with Russia could possibly change the foundations for the future development of trade and accordingly diminish the trade with other markets. The question is to what extent trade with Russia will increase in five years. The potential of trade with Russia is largely dependent on the economical situation and political standpoint in Russia. However, it is reasonable to assume that Russia will gradually become a more important trading partner of the Baltics and that this will at least be evident within five years.

The further developments of the Baltic countries in terms of industry structure and goods, production costs and so on, will affect their trade. According to the interviewed companies and organizations there is a general fear of loosing the current importance as a low-cost production site in Europe in time with further developments. On the other hand, there is also the fear of coming to a standstill, not being able to proceed in the development. To improve the potential to the United Kingdom and the United States concerning the two relevant commodity groups, the Baltic industries must develop to increase the proportion of finished manufactured goods since these goods generate a much higher value. Additionally, more companies in the Baltics (especially in Estonia) obviously need to attain an interest in the United Kingdom and the United States (and the other way around), if the export value is to increase considerably in the near future. A further question is if an improved cooperation between the Baltic states could enhance their trade towards distant trading partners as the United States. Though, there are no indications of such cooperation within the next five years the reason for which will not be more closely considered here.

It is clear that the growth of total Baltic exports to the United Kingdom and the United States during the previous five years have been immense especially for the United States. There is reason to believe that the substantial growth depends

on the undeveloped trade relations with the United Kingdom and the United States prior to 1996 and the Russian crisis, which caused especially Lithuania (since Lithuania up to this moment had extensive trade with Russia) to make a U-turn and redirect trade to the West. Therefore, it cannot be considered realistic that growth will continue to be that extensive in the next coming five years. In addition, assuming that the economic recession will slow down trade growth as it already has this year, resulting in a negative growth of trade in Estonia the trade to such a distant market as the United States should not increase dramatically within five years.

The additional question is what the proportion of basic manufactures and finished manufactures will be out of total foreign trade to the United Kingdom and the United States since this naturally affects the growth rates of the two relevant commodity groups. The share of processed goods is bound to increase in the future at the expense of less processed goods. With regard to the fact that Estonia so far has focused a large extent of its exports on subcontracting it is obligated to enhance the proportion of manufactured goods gradually. The question is how fast this development will be. Latvia has a structural problem since it exports mainly goods that have a low level of processing (wood and textile) while simultaneously importing highly refined products (electronic and transport equipment). Thus, the question is to what extent its composition of exports will change within five years. Latvia and Lithuania have been predicted to overtake Estonia's subcontracting role in the near future, which naturally indicate a further step in their development. Yet, subcontracting is usually composed of more basic manufactures than finished goods. All the countries will eventually loose their low-cost production advantage, especially as a consequence of a EU-membership. However, since the Baltic countries will most likely not be accepted as members until the end of this five-year period, it is likely that exports will overall remain principally focused on less processed products. Still, it should be reasonable to assume that the development of finished manufactured goods will grow faster the next five years since the Baltic countries obviously have developed since the mid-1990's.

The annual growth of exports of manufactured goods was calculated to 6,8% from 1995-1999 in the first growth scenario in Chapter Five. There is reason to

believe that the exports of manufactured goods with these trading partners will increase at a higher annual growth rate than the average annual growth rate of 6,8% since the share of manufactured goods should increase more extensively compared to the previous five years. Still, even if the growth of trade with the United Kingdom and the United States will continue to be high, the question is if the growth rate will reach an annual growth of 15,3% as was implied in Chapter Five.

Previously, the conclusion was that the triangular curve seemed to be the most probable scenario. However, taking a more comprehensive picture into account the scenario has been reconsidered. Other determinants of the development indicate that trade with the United States and the United Kingdom will probably not increase as dramatically during the next five years, particularly when considering only manufactured goods. As a result, a more cautious annual growth rate (the square-shaped curve, 10,2%) than the triangular curve has been chosen as the most probable scenario for the near future.

The presumptions underlying the change of the growth rate scenario are that the world recession will have a certain negative impact on the Baltic countries' foreign trade during the next five years. It is assumed that the growth of exports will temporarily slow down and that further increase will thus be postponed. Moreover, foreign direct investments from the United Kingdom and the United States will not increase to a large extent due to the recession, which implies that the trade relations between the Baltic countries and these markets will not be strengthened in this way. In addition it seems as if other currently important trading partners (Germany, Sweden, Finland) will not be less prioritized and thus, that the United Kingdom and the United States have to compete with these markets to grow at a considerably fast rate. Actually, in Estonia's case there seems to be more potential of a more central route of trade. Additionally, this prediction assumes that the trade with Russia will gradually begin to increase at a certain expense to other trading partners and that this pattern will at least be visible in a five-year period. Nevertheless, one optimistic influencing factor that has been acknowledged is the gradual increase of production of manufactured goods. This trend is predicted to continue which means that manufacturing production will grow at a faster pace in the next five years

compared to the previous five-year period. All of these assumptions contribute to the selected annual growth rate of exports of manufactured goods to the United Kingdom and the United States. However, this also gives an indication to the overall picture of the prediction of foreign trade in the Baltic countries.

Finally, it can be concluded that the reversed flow of manufactured goods (imports from the United Kingdom and the United States) exceed the export flow and would accordingly have been interesting to analyze further. Actually, this could be equally interesting for the Port of Göteborg since it could also handle the reversed trade from the United Kingdom and the United States to the Baltic states. However, this research has been mainly export focused and the importance of imports in this case was recognized quite late in the research process. Therefore, more close conclusions can unfortunately not be drawn regarding imports.

The foreign trade of the Baltic countries has gone through significant changes during a decade of development. Actually, this development is far from being completed and new trade partners and trade patterns will probably emerge within another decade. Accordingly, the Baltic trade is still so undeveloped that the further development can take a variety of directions. This makes it very difficult to predict the foreign trade development. Although five years has been concluded not being enough to see a substantial potential of exports to the United Kingdom and the United States the trends of the further development path of foreign trade will at least be much more evident in 2006. Hence, it will probably be easier to see whether the trade will develop to the west, east or south in five years. The Port of Göteborg should definitely take the opportunity to participate in this development since the potential of trade with the United Kingdom and the United States should be as promising as, for example, Germany during a long-term period.

8.4 FURTHER RESEARCH

The studied subject in this thesis is very complex and uncertain, particularly since it is aiming at some kind of forecast of the future. Accordingly, a number of assumptions and delimitations have been made, which naturally narrow the

scope substantially. Consequently, there are a vast number of potential areas where further research could be undertaken.

This study has mainly focused on the potential of **exports** from the Baltic countries, thus generally disregarding the opposite trade flow of imports into the Baltics. Therefore, this presents an additionally research area of major interest, especially since imports originating from the United Kingdom and the United States were concluded to be greater than exports.

Further, the future potential of foreign trade in this research is largely based on the opinions of a number of actors on the Estonian market as well as on several internal and external factors assumed to have a certain impact on the outcome of foreign trade. It would be interesting to conduct a study focused on more extensive calculations of forecasting resulting in more precise future potential scenarios.

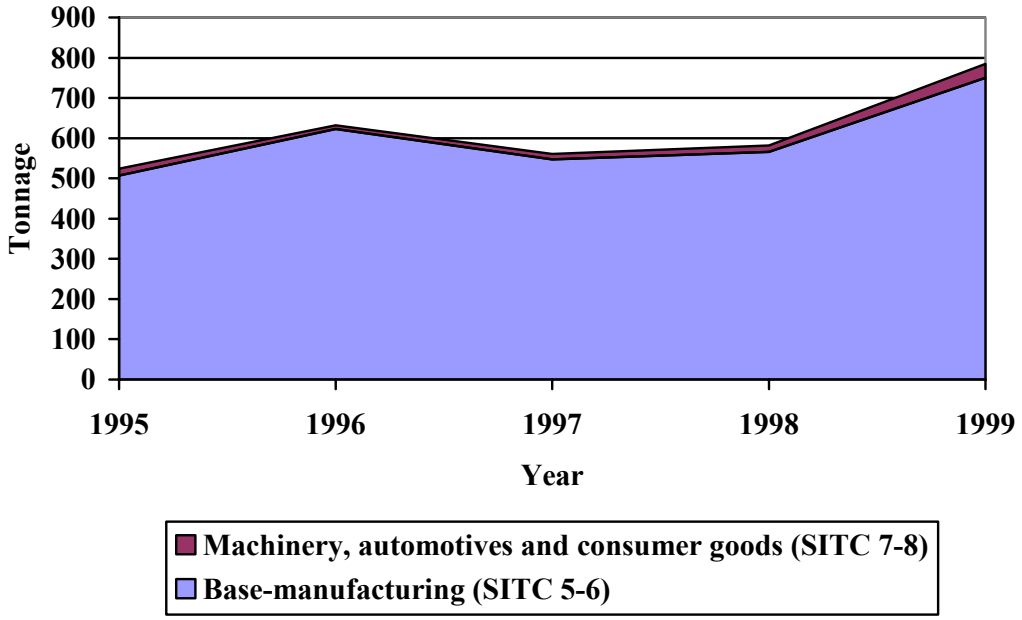
Another area of further interest would be to conduct more extensive field-studies in all the Baltic countries with a larger number of companies with the purpose of including most of the exports from this region. This would certainly increase the accuracy of predicting the future pattern of foreign trade.

This study has focused mainly on the prospective of European trading partners. The future potential of additional trading partners in for example the Americas or Asia would be a totally different research.

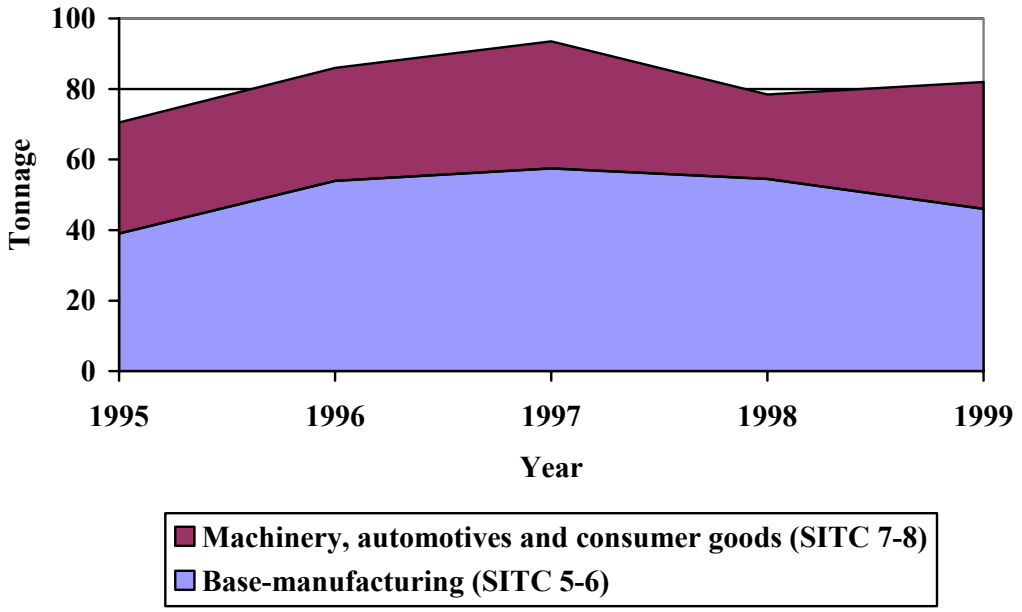
Additionally, this study would have had a totally different outcome if transit trade to and from Russia had been more closely examined. Consequently, future research of foreign trade in the Baltic countries could consider all commodity groups including transit trade.

APPENDIX

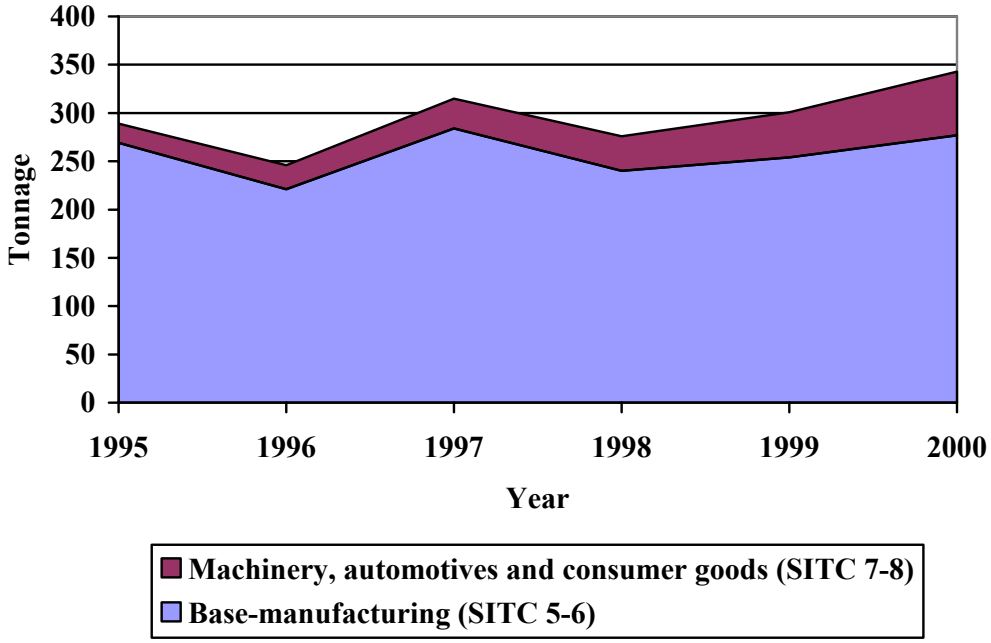
Baltic exports of manufactured goods in quantity to the United Kingdom and the United States 1995-1999



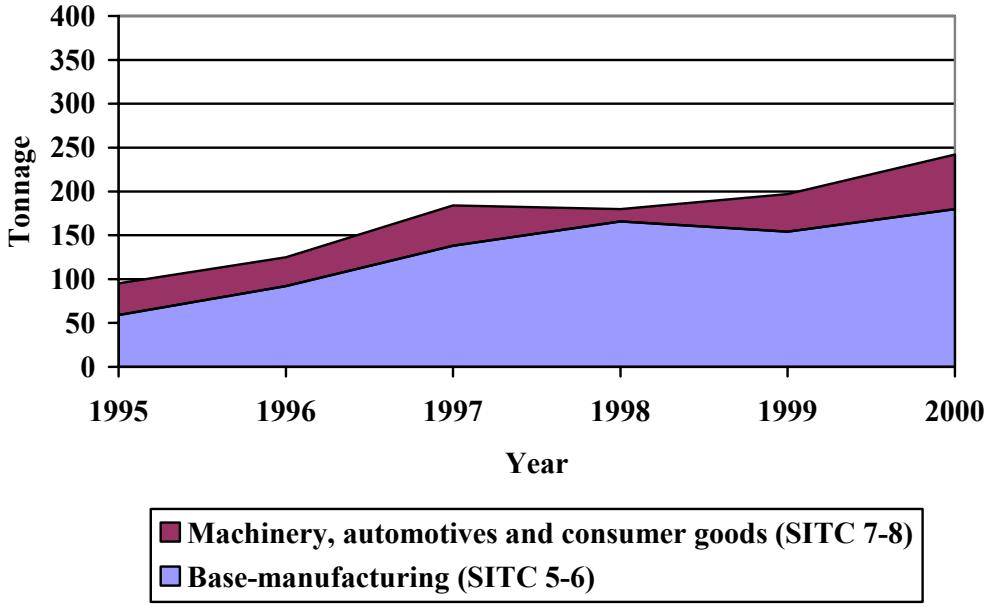
Baltic imports of manufactured goods in quantity from the United Kingdom and the United States 1995-1999



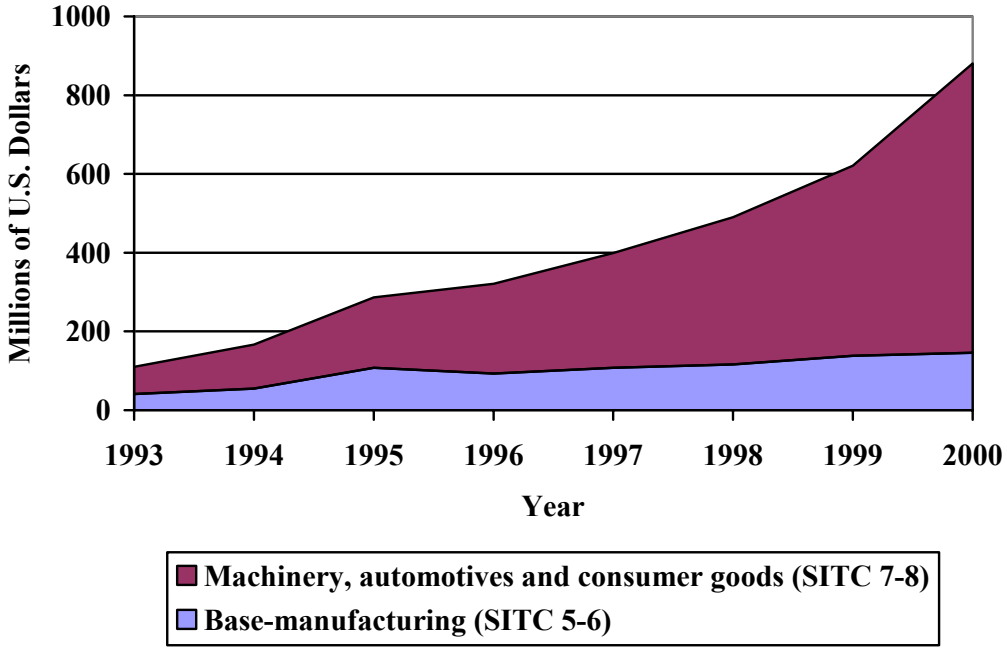
Baltic exports of manufactured goods in quantity to Sweden 1995-2000



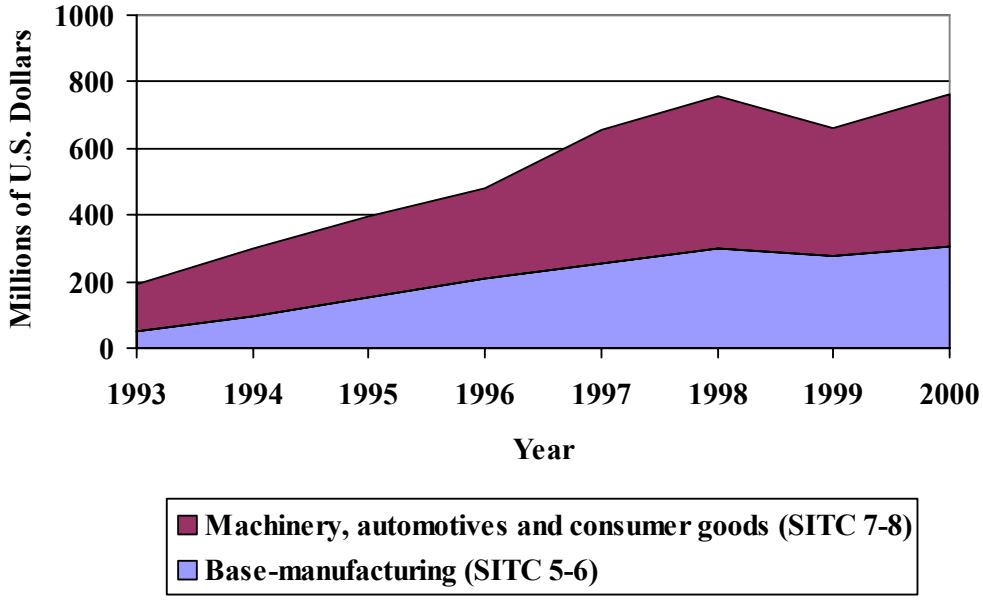
Baltic imports of manufactured goods in quantity from Sweden 1995-2000



The Baltic's total exports of manufactured goods in value to Sweden 1993-2000



The Baltic's total imports of manufactured goods in value from Sweden 1993-2000



Source; OECD, ITCS International Trade by Commodities Statistics, 2001.

INTERVIEW QUESTIONS

- **COMPANY/ORGANIZATION PRESENTATION**

  - Short history of the company?
  - When was the company founded?
  - Examples of product range?
  - Foreign ownership-how much has the company been affected by it?
  - What is this organization responsible for?
  - What type of work is done?

- **COMPANY EXPORTS AND PRODUCTS**

  - Annual turnover?
  - How much out of your production do you export?
  - Main trading partners/what countries do you export to?
  - Trade with the United Kingdom and/or the United States?
  - If yes- how much/to what extent- future potential?
  - If no- future potential?

- **IMPORTS**

  - Do you need to import some resources for production?
  - Where from?

- **FUTURE**

  - What is the future potential of your industry sector in general? (growth, GDP, sales forecast?)
  - How do you picture your company in 5-years time?
    - Future development of trade and export?
    - Trade partners/customers?

- **ESTONIAN MARKET- INVESTMENT CLIMATE**

  - What is the economic situation like in Estonia? (GDP/Industrial growth/Inflation/Unemployment)
  - The largest and most important industries in Estonia?
  - The largest exporting companies in Estonia?

- Most important foreign markets/trading partners for the most important Estonian industries?
- What would you say are the main reasons of investing in Estonia (from the viewpoint of foreign companies)? –Short and long-term?
- The procedure of investment (step by step or direct)?
    - Easiest way to get access to the Estonian market?
    - Most common way? (Greenfield, Joint Venture)?
- What are the current policies for FDI? What obstacles/restrictions are there for foreign investment in Estonia (government)?
- Forecast for the future economic development in Estonia? (GDP-growth, Industrial growth)
- Which factors would you say would have most affect on the foreign trade development?
    - EU-membership?
    - Government expenditure or other measurements?
    - External factors like the economic development in the US?
    - Stable currency?
    - Oil price?
    - Costs of building infrastructure and telecommunication networks?

- How will the EU-membership affect (foreign) businesses?
  What are the main obstacles in becoming a Member of the EU?

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