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Preferential Trade Agreements: The Specific Aspects of the Integration of the Baltic States into the EU

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Introduction

The number of preferential trade agreements (PTAs), establishing free trade areas (FTA) and customs unions (CU) has increased rapidly since the early 1980s. These agreements are preferential in the sense that they offer free trade to members but protection against non-members. The first attempt to theorize about the subject was made by the great economist Jacob Viner in 1950. Ever since, the two-sided nature of preferential trade agreements has inspired economists around the world (Baldwin R., Bhagwati J., Krugman P., Panagariya A., Winters A., Wonnacott P, etc.). In 1950s and 1960, the theoretical analysis focused, in particular, on static questions concerning welfare effects. During recent years, interest has shifted to more dynamic questions: whether preferential trade arrangements hinder or promote the further liberalization initiatives and the process towards worldwide liberalization of trade.

Compared to the international trading powers such as the United States or the European Union, the three Baltic States, Estonia, Latvia and Lithuania are small. Altogether, they form a market size of about 8 million people with GNP per capita less than 20 percent of that in the United States.[1] Small economies like the Baltic States are price takers in the world market. Traditional trade theory suggests that trade restrictions such as tariffs and quotas are costly to this type of economy. They divert resource allocation away from more productive uses and distort prices. In the absence of other distortions, a small competitive economy would maximize its welfare by having no tariffs at all. Indeed, the Baltic countries are relatively open economies. For example, the Baltic Free Trade Area for industrial products entered into force in January 1996 and for agricultural products in 1997. An agreement on the abolition of non-tariff barriers to trade among the Baltic States has been concluded and negotiations are proceeding on liberalization of services market. Trade with other countries, especially with the EU, with some of the Central and Eastern European and also with the EFTA countries, is also largely liberalized.

The aim of this study is to analyze preferential trade arrangements between the Baltic States and other countries, the EU in particular. The theory on regionalism constitutes the overall basis of the study and is used to explain some of the static and dynamic effects related to preferential trade arrangements. The work hypotheses tested are the six theses of new regionalism, presented by Wilfred Ethier:[2]

1. the new regionalism typically involves one or more small countries linking up with a large country,
2. regional arrangements are regional geographically,

3. the small countries have recently made, or are making, significant unilateral reforms,
4. regional arrangements often involve deep integration,
5. dramatic moves to free trade between members are not featured, and
6. the liberalization achieved is primarily by the small countries."

The Study is organized in seven parts. Chapter 2 presents a theoretical overview on regionalism including some of the static and dynamic effects related to preferential trade arrangements. Chapter 3 focuses on the first two hypothesis of new regionalism; the role of geographical proximity in regional trade arrangements and the tendency of small countries linking up with a large country. The current regional trade arrangements of the Baltic States are reviewed. In addition, the top trading partners, the volume and the composition of the Baltic foreign trade is discussed. In Chapter 4, the hypotheses of new regionalism concerning the small countries making unilateral reforms and regional arrangements involving deep integration are analyzed in the context of the European Union eastern enlargement process. Chapter 5 takes a closer look at the preferential trade agreements – Association Agreements – between the Baltic States and the European Union. In particular, the study focuses on the claims that new regionalism involves modest trade concessions and that the liberalization achieved is primarily by small countries. The agreements are analyzed in terms of coverage, the degree of liberalization in industrial and agricultural trade, rules of origin and other commercial policy measures. While Chapters 3-5 evaluate whether the six specific hypothesis of new regionalism apply to the preferential trade agreements between the EU and the Baltic States, Chapter 6, in turn, extends the analysis from the EU to the multilateral level. In particular, the discussion returns to the more general, but fundamental question of new regionalism: whether preferential trade agreements hinder or promote further trade liberalization initiatives. First, the main principles of the World Trade Organization (WTO), including its policy towards preferential trade agreements are discussed. In addition, Association Agreements between the EU and the Baltic countries are asessed from the perspective of WTO principles. Chapter 7 concludes the study.

International Trade Theory:
Regionalism and Preferential Trade Agreements

Old Regionalism - Static and Systemic Effects of PTAs

Regionalism can generally be defined as a tendency towards some form of preferential trading arrangement between a number of countries belonging to a particular region.[3] Furthermore, the word "preferential" refers to a club; countries that do not belong to a particular regional arrangement are discriminated against. Academic literature makes a distinction between old and new regionalism. In the 1950s and 1960s, many attempts were made around the world to form regional trading clubs: customs unions (CUs) and free trade areas (FTAs). However, most of these attempts, excluding the European Common Market, did not really succeed. Those efforts are associated with what is sometimes called the "old" or "first" regionalism.[4] The re-emergence of regional trade agreements (RTAs) inside Europe has been substantial since the establishment of the European Community. While in 1960s, there were only three essential RTAs among European countries, today the number of RTAs exceeds 90.[5] About 15 of these RTAs are inside Western Europe, 20 inside Eastern Europe, and around 55 between Eastern and Western European countries.[6] Worldwide, GATT/WTO has been notified of 184 regional trade agreements, of which 109 are still in force.[7] The last decade, during which many of the above mentioned RTAs have been established, is sometimes called the "new" or "second" regionalism.

The discriminatory feature of regional trade agreements has been subject to extensive research among economists. During the first regionalism, the theoretical analysis focused, in particular, on static questions concerning welfare effects. The early development of the theory of Preferential Trade Agreements (PTAs) has been associated with academics, such as Jacob Viner (1950 and 1951), James Meade (1953 and 1955), and Richard Lipsey (1958). Viner, in his famous book of "the Customs Union Issue", made a distinction between trade creation and trade diversion. The trade-creating union would increase trade among the members at the expense of inefficient industries inside the member countries. The trade-diverting union, on the other hand, would create trade at the expense of more efficient industries in non-member countries. To put it slightly differently, Viner argued that a preferential trade arrangement, such as a customs union, is trade-creating when at least one of the members must benefit, both may benefit and the two together have a net benefit. The outside world, however, loses in the short-run; but it can gain in the longer-run, due to the general diffusion of the increased property of the customs area. Where trade diversion takes place, at least one of the member countries will be injured, both may be injured, the two together will suffer a net loss, and there will be damages to the outside world.

Ever since Viner's attempts in theorizing about PTAs, trade theorists and policymakers have been challenged by the question of whether the issue of trade diversion should be taken seriously, or would any move towards free trade, even if preferential, be welfare-improving. In general, economic theory is not fully against PTAs. The rest of this chapter will focus on some of the modern extensions of Viner's analysis.

The claim of "Natural Trading Partners"[8] states that if PTAs are formed among "natural trading partners", i.e. countries among which the initial volume of trade is high, and the distance between them is low, one could expect them to be welfare-improving for the members. The argument implies that high initial volume of trade among members and a short geographical distance between trading countries reduces the potential for trade diversion. This argument has some similarities with the traditional gravity theory on bilateral trade patterns, according to which trade between two countries depends positively on incomes of trading countries and negatively on the distance between them.[9]

In contrast to the 'natural trading partner' argument, it has been argued that the actual trade diversion will reflect not the average initial trade volumes - "The Volume-of-Trade Criterion"- but the underlying fundamentals such as substitution among products.[10] Under these circumstances, with each member country specialized in a different product when all products are imperfect substitutes, the steady preferential reduction of tariffs by one country on another will first improve its welfare and then progressively reduce it at some stage. Consequently, reaching a 100% reduction, an FTA may reduce welfare even below the starting level.[11] This argument that PTAs with less than 100 percent preferences are superior to FTAs was first introduced by Meade (1955). The key to this result is the declining marginal utility for the consumption of each variety. The welfare effects of trade creation become negligible at a certain point, while trade diversion effects become larger. This is because varieties of products with larger marginal utility, meaning those products from other foreign non-member countries, are replaced by product varieties from member countries, which have smaller marginal utility.[12]

One approach along the lines of Viner is that of Kemp and Wan (1976). They showed that if countries were to form a CU, and could choose their external tariff, they could always form a CU, which left the welfare of the non-members unchanged while improving member countries' welfare.

An interesting extension to the static welfare effects of PTAs deals with their systemic effects. They are caused by that fact that one tries to restrict or liberalize trade on the basis of which product comes from which country. In order to do so, a country must establish a 'rule of origin', which often leads into problems of arbitrary definitions of origin. This difficulty is present both in FTAs and CUs (although in a smaller scale than in FTAs). For example, an FTA inevitably requires that the origin is defined for all traded products. This can lead to arbitrariness in trying to identify the origin of products. The problem becomes even more acute because in an FTA there are different external tariffs among members which, in turn, creates the fear of non-member products coming into one's territory at lower tariff than one's own (by entering through another lower-tariff member country). Finally, FTAs are often negotiated at different points of time and with different time schedules for reaching zero tariffs. As a result, we can find a complicated set of applicable tariffs on the same product. These rules generate a world of preferences increasing transaction costs and facilitating protectionism. This phenomenon is known as the "spaghetti bowl" phenomenon.[13]

New Regionalism and Dynamic Approach

Since the old regionalism, the whole international trading environment has changed dramatically. First of all, the multilateral liberalization of trade in manufactured goods among the industrial countries is much more complete now, thanks to the GATT/WTO rounds of multilateral tariff reductions. In addition, less developed and former communist countries are nowadays more actively trying to integrate into the multilateral trading system. The old inward-oriented, communist and import substitution policies have given way to more market-oriented and open trade policies.

Motives behind new regional trade arrangements may be country – or region –specific. Nevertheless, some common characteristics of the new regionalism have been observed:

> "regional integration now usually involves reform-minded small countries purchasing with moderate trade concessions, links with a large, often a neighboring country that involve deep integration but that confer relatively minor trade advantages." [14]

While the majority of the so called deep integration schemes are taking place in Europe, the other regional trade arrangements – those established in North and Latin America - have involved relatively shallow integration with long transition periods, and a focus primarily on statutory border measures.[15]

In addition to the international trading environment, the focus of theoretical research has also changed during the new regionalism. While the first regionalism concentrated on static welfare effects of PTAs, the new regionalism has put more emphasis on dynamic issues: i.e., whether PTAs hinder or promote the worldwide nondiscriminatory reduction process of trade barriers. Furthermore, if PTAs pose a threat to global trade liberalization, what is the nature of this threat?

Among the trade theorists, the question of how preferential trade agreements influence trade liberalization worldwide remains open. Just as there are various interpretations about the static welfare effects of PTAs, theories about dynamic effects provide mixed results as well. [16]

In terms of trade liberalization in general, it has been argued that dynamic output effects of trade liberalization are substantial, and perhaps significantly larger than the static effects analyzed in earlier studies.[17] The reasoning behind this argument is that trade liberalization may, other things being equal, raise the marginal productivity of human and physical capital. Provided that the steady-state levels of these factors are determined endogenously, trade policy can have an influence over these levels. Consequently, liberalization of trade can have a dynamic effect on output and welfare as the economy moves towards a new steady state. The overall welfare effects resulting from trade liberalization and the additional output depends on the degree of external scale economies.[18]

Referring to the studies on regional trade liberalization in particular, it has been argued that when PTAs (preferential trade agreements) and MTN (multilateral trade negotiations) are separable (meaning that one neither hurts nor helps the other), PTAs may either improve or reduce welfare immediately (in the static sense). In either case, the time-path could then be stagnated, which would imply a fragmentation of the world economy and no further expansion of the initial PTA. This type of time-path would also fall short compared to the time-path representing the worldwide freeing of trade on a nondiscriminatory basis at a specified time (the ultimate goal). An alternative path would lead to multilateral free trade for all through a continued increase in PTAs. The other situation is when PTAs and MTN interact. In this case, the MTN time-path becomes a function of whether the PTA time-path travels simultaneously.[19]

One of the studies on PTAs suggests that preferential trade arrangements such as free trade arrangements complicate the way in which externalities associated with trade are transmitted across countries.[20] Under these circumstances, the principle of reciprocity[21] can no longer produce efficient multilateral outcomes for its members. The same study finds an interesting exception, namely that a limited number of customs unions in the multilateral trading system is actually possible, but only when the member countries share similar political preferences.

Many of the dynamic time-path analyses take the membership of a PTA and its expansion as exogenous and examine its consequences. Some studies, instead, treat the time-path as endogenous. Under this assumption, one of the conclusions has been that the PTA will eventually create a domino effect, with outsiders wanting to become insiders, increasing the incentives to add members to preferential trade area.[22] The main idea behind this argument is that the cost for non-membership (tariffs that member countries' firms do not need to pay) drives firms to lobby for pro-integration. This (if the non-member country's government was previously indifferent to membership) may enlarge the market and add countries one after the other (the domino). At the end, this could lead to a point, where trade barriers have been freed worldwide (a situation where every country belongs to the same preferential trading area).

While some economists argue that any liberalization makes further liberalization easier, provided that it increases both imports and exports,[23] others instead suggest that the bilateral FTAs can undermine political support for multilateral free trade.[24] In addition, PTAs may reduce the incentive of the two member countries to liberalize tariffs reciprocally with the non-member world, and this incentive could be so reduced that it would make multilateral trade liberalization impossible.[25]

Some of the most recent studies about static welfare effects of regional integration arrangements indicate that effects are more positive than negative. For example, it has been shown that regional trade arrangements are welfare improving if they are formed by countries which are predominantly least-cost producers of export goods, or if they give rise to increased imports from all trading partners.[26] However, the same study concludes that currently, there are hardly any, if any, such customs unions or free trade areas that would fully meet these criteria. Recent empirical studies, which have focused on regional trade arrangements in Europe and North America, suggest that presently operating regional trade arrangements have caused a modest positive impact on member countries and a minor impact on non-member economies.[27] In addition, there seems to be less evidence indicating that a well-functioning regional trade arrangement has actually had negative welfare effects on member or non-member countries.[28]

Foreign Trade and Regional Trade Arrangements of the Baltic States

Table 1 illustrates the variety of preferential trade arrangements currently existing between the Baltic countries and other countries. In addition to the EU, Estonia has Free Trade Agreements with EFTA countries, the Czech Republic, Slovakia, Slovenia, Turkey and Ukraine. Furthermore, negotiations to establish free trade agreements were concluded with Poland and Hungary last year.[29] Latvia has concluded free trade agreements with the EU and the EFTA, the Czech Republic, Slovakia, Slovenia and Turkey. Moreover, Latvia has a free trade agreement with Ukraine.[30] The provisional application of the Free Trade Agreement with Poland is proceeding. Latvia is presently also negotiating free trade agreements with Hungary and Romania, and is planning to start negotiations with Bulgaria.[31] In the case of Lithuania, Free Trade Agreements have been concluded, in addition to the EU and EFTA members, with the Czech Republic, Poland, Slovakia, Slovenia, Turkey and Ukraine. Moreover, a free trade agreement has been initiated with Hungary, and negotiations with Romania are proceeding.[32] Finally, the three Baltic countries are part of their own Baltic Free Trade Area.

All in all, two conclusions can be made. First, smaller Baltic countries seem to have regional trade arrangements with larger countries. Second, all of these countries are in Europe and are geographically relatively close in location to the Baltic States. Hence, the first two hypotheses of new regionalism – small countries usually linking up with a large country and regional arrangements being regional also geographically - seem to apply to the preferential trade arrangements between the Baltic States and other countries.

Table 1. Regional Trade Agreements of the Baltic States

	With the EU	With Other Council of Europe Members[33]
Estonia	FTA/Europe Agreement[34]	BFTA[35] member
		FTAs with EFTA[36] members, Cze, Slk, Slo, Tky, Pol, Hun, Ukr[37].
Latvia	FTA/Europe Agreement	BFTA member
		FTAs with EFTA members, Cze, Slk, Slo, Tky, Ukr.
Lithuania	FTA/Europe Agreement	BFTA member
		FTAs with EFTA members, Cze, Pol, Slk, Slo, Tky, Ukr.

Have these preferential trade arrangements been welfare improving for the Baltic economies? Have they created trade instead of diverting it? Tables 2-4 illustrate the Baltic States' volume of trade with their top trading partners in 1993 and 1998. Tables 5-7 illustrate the product composition of trade during the same years.[38] Several interesting observations can be made. First, statistics indicate that Baltic foreign trade is currently focused on the European continent (as the collapse of the Former Soviet Union broke old trade relations and urged a shift towards new, western markets). Second, Baltic foreign trade is focused not only in terms of the continent, but also as regards the concentration of trade inside Europe. The EU appears to be the most important trading partner for all Baltic economies. Also the trade volume with the EU has increased to a large extent. This indicates that preferential trade agreements between the Baltic countries and the EU have had trade-creating influence. Third, inside the EU, some of the Union members have stronger trade relations with the Baltic States than others.[39] Especially for Estonia and Latvia, the most dominant EU trading partners are Finland, Sweden and Germany. Germany, together with Italy, Denmark and the U.K., seem currently to be the most active EU-traders with Lithuania. Another interesting observation that can be made form the trade data is that, contrary to earlier expectations, the preferential free trade agreements (in industrial and agricultural products) among the Baltic States have not substantially increased intra-Baltic trade flows. One of the main reasons for the low level of intra-Baltic trade is that the trade structure of the three states is largely competitive rather than complementary.[40] Another explanation for low levels of intra-Baltic trade could be the fact that the Baltic market was/is relatively small market, and therefore not as attractive as, for example, the EU market. Furthermore, the cooperation initiatives might have been dampened if they were seen to be competing with efforts aimed at EU accession. In addition, as has been the case in CEFTA, resistance to new bureaucracy, and consequently a lack of official and effective enough structure that could enforce the regional rules has been an obstacle to the further regional integration efforts.[41] Also, the lack of trade finance and the imperfect regulatory framework may also have imposed constraints on the development of intra-Baltic regional trade. Finally, one important reason for low levels of intra-Baltic trade compared to EU-Baltic trade deals with macroeconomic framework, namely the Baltic countries generally have lower price levels than the EU. [42]

Table 2. Estonia's Trading Partners, percentage of total exports or imports (in million kroons)

1993				1998			
Exports		**Imports**		**Exports**		**Imports**	
Total	100 (10636.2)		100 (11831.6)		100 (45 236.7)		100 (66 975.5)
Russia	23 (2408.5)	Finland	28 (3303.5)	Finland	19 (8473.3)	Finland	23 (15 163.8)
Finland	21 (2202.6)	Russia	17 (2033.3)	Sweden	17 (7463.2)	Russia	11 (7437.2)
Sweden	10 (1007.5)	Germany	11 (1272.8)	Russia	13 (6082.3)	Germany	11 (7258.4)
Latvia	9 (913.5)	Sweden	9 (1055.0)	Latvia	10 (4294.7)	Sweden	9 (6054.5)
Germany	8 (851.3)	Holland	4 (429.1)	Germany	6 (2492.2)	Japan	5 (3284.8)
Holland	4 (430.9)	Lithuania	3 (391.0)	Ukraine	5 (2266.6)	U.S.	5 (3095.7)
Other	26	Other	27	Other	30	Other	36
EU	48 (1894.9)	EU	61 (2760.7)	EU	55 (24769.4)	EU	60 (40 278.4)
CIS	30 (3228.7)	CIS	22 (2551.1)	CIS	21 (9453.1)	CIS	14 (9489.3)
Other Baltic States	12 (1307.4)	Other Baltic States	6 (658.4)	Other Baltic States	14 (6421.2)	Other Baltic States	4 (2448.9)

Source: Statistical Office of Estonia.

Table 3. Latvia's Trading Partners, percentage of total exports or imports (in thousand lats)

1994				1998			
Exports		**Imports**		**Exports**		**Imports**	
Total	100 (553437)		100 (694588)		100 (1068852)		100 (1881285)
Russia	28 (155719)	Russia	24 (164178)	Germany	16 (166822)	Germany	17 (315547)
Germany	11 (58271)	Germany	14 (94011)	U.K.	14 (144343)	Russia	12 (221290)
U.K.	10 (53894)	Finland	9 (59102)	Russia	12 (129007)	Finland	10 (179189)
Sweden	7 (38114)	Sweden	6 (44494)	Sweden	10 (110017)	Sweden	7 (135096)
Ukraine	6 (32727)	Lithuania	6 (41243)	Lithuania	7 (79325)	Estonia	7 (124827)
Lithuania	6 (30694)	Estonia	4 (24412)	Estonia	5 (48526)	Lithuania	6 (118518)
Other	32	Other	37	Other	36	Other	41
EU	39 (217044)	EU	41 (281685)	EU	57 (604459)	EU	55 (1039492)
CIS	43 (236375)	CIS	30 (211600)	CIS	19 (202611)	CIS	16 (301063)
Other Baltic States	8 (45054)	Other Baltic States	10 (65657)	Other Baltic States	12 (127851)	Other Baltic States	13 (243345)

Source: Statistical Office of Latvia.

Table 4. Lithuania's Trading Partners, percentage of total exports or imports (in million litas)

1993				1998			
Exports		**Imports**		**Exports**		**Imports**	
Total	100 (8707.0)		100 (9798.2)		100 (14849.2)		100 (23186.2)
Russia	33 (2884.7)	Russia	54 (5256.6)	Russia	17 (2484.6)	Russia	21 (4891.2)
Ukraine	11 (977.5)	Germany	10 (945.3)	Germany	13 (1919.0)	Germany	18 (4187.3)
Belarus	7 (641.2)	Ukraine	6 (609.3)	Latvia	11 (1659.5)	Poland	6 (1299.0)
Latvia	7 (635.7)	Belarus	3 (325.8)	Belarus	9 (1307.4)	Italy	5 (1032.0)
Poland	7 (608.0)	Denmark	2 (239.3)	Ukraine	8 (1192.3)	Denmark	4 (879.9)
Germany	7 (592.0)	Netherlands	2 (223.9)	Italy	4 (595.9)	U.K.	4 (857.1)
Other	28	Other	23	Other	38	Other	42
Europe[43]	93 (8117.5)	Europe	94 (9244.0)	EU	37 (5551.1)	EU	47 (10960.0)
CIS	5	CIS	26	CIS	36 (5371.0)	CIS	26 (6022.2)
Other Baltic States	10 (854.5)	Other Baltic States	2 (221.2)	Other Baltic States	14 (2061.2)	Other Baltic States	3 (775.3)

Source: Statistical Office of Lithuania.

An interesting observation indicated by trade data concerns the Central and Eastern European trade partners. With the exception of Poland, none of the Central and Eastern European countries with which the Baltic countries have free trade agreements, appears (yet) on the top trading partner list. This result could partly reflect the fact that some of these free trade agreements have been concluded only recently and their effects are therefore still to be seen. Finally, although the Baltic countries do not have preferential trade agreements with Russia, the argument linking geographical proximity with trade partners is particularly true in case of Russia. Russia is located close to the Baltic States. Moreover, it has been, and still is, an important trade partner with the Baltic economies.

With regard to the general composition of foreign trade, the main changes are illustrated in Tables 5-7. In Estonia (Table 5.), the share of machinery has increased significantly and, at present, forms the largest part of foreign trade, both in exports and imports. Although the overall share of foodstuffs in foreign trade has declined, it still remains significant. In addition to machinery, trade in wood, wood articles, paper and textiles constitute other important parts of Estonia's exports. Only minor changes have taken place regarding the shares of chemical products and textiles in Estonian foreign trade.

In Latvia, exports are still dominated by trade in wood and related articles (Table 6). The second on the 'most traded product' list is textiles. Their share in foreign trade, both in exports and imports, has not changed significantly over the years. While the shares of both exports and imports of foodstuffs have declined, no substantial changes have taken place in the trade of chemical products. The role of machinery has increased significantly during the period in question and now constitutes the biggest share of imports.

As in Estonia, trade in machinery forms the biggest part of foreign trade in Lithuania (Table 7). Its share both in exports and imports has increased over the last years. Mineral products and textiles constitute the second and third most important parts of foreign trade. While the share of exported minerals has remained relatively steady, the share of imported minerals has declined considerably. The export share of textiles has slightly increased. Finally, during the years under review, the share of chemical products in the overall trade has remained relatively steady, whereas food exports have declined considerably.

Referring to the composition of trade with individual PTA partners, the analysis is partly constrained by the limited data available from the Baltic statistical sources.[44] Given the importance of the EU as a trading partner for the Baltic States, some comments can be made concerning the composition of EU-Baltic trade.[45] Estonia presently imports mainly machinery and electrical equipment, textiles and agricultural products from the EU. The main products exported to the EU are machinery, textiles and wood. Latvia's imports from the EU consist primarily of machinery, foodstuffs and textiles. The most common products exported to the EU are wood products, textiles and base metals. Finally, Lithuania exports mainly textiles, machinery, mineral products and chemicals to the EU. Imports from the EU consist primarily of machinery, vehicles and textiles.

The recent study by Kaitila & Widgren (1999) shows that, measured for 1993 and 1996, the overall level of intra-industry trade between the EU and the Baltic countries was relatively low, but that it has been increasing relatively rapidly. In addition, the study suggests that the Baltic States are very similar to one another in the EU markets in terms of the Baltic economies' revealed comparative advantage. Their comparative advantage is seen in wood and related articles, as well as in oil, which is mainly transit trade from Russia. Moreover, the study suggests that the Baltic countries' potential comparative advantage in the future lies in processed agricultural goods, which currently play an important role especially in the Baltic exports to other transition countries.[46]

Table 5. Estonia's trade by groups of goods (percentage of exports or imports)

1993			1998		
	Exports	Imports		Exports	Imports
Foodstuffs	23.4	14.7	Foodstuffs	15.9	16.9
Mineral products	7.6	15.5	Mineral products	3.8	5.9
Products of chemical industry	4.7	6.4	Products of chemical industry	7.2	8.1
Textiles and footwear	13.5	11.5	Textiles and footwear	11.6	7.5
Wood, paper etc.	8.1	2.8	Wood, paper etc.	14.5	4.3
Base metals and articles of base metal	10.4	5.0	Non-precious metals and metal products	8.5	9.3
Machinery and equipment	7.6	17.7	Machinery and equipment	19.6	25.4
Transport vehicles	10.6	14.2	Transport vehicles	4.8	9.4
Other	14.1	12.2	Furniture etc.	4.8	1.6
			Other goods	7.0	7.4
Total	100.0	100.0	Total	100.0	100.0

Source: Bank of Estonia, Statistical Office of Estonia

Table 6. Latvia's trade by groups of goods (percentage of exports and imports)

1995			1998		
	Exports	Imports		Exports	Imports
Foodstuffs and animal products	15.7	10.2	Foodstuffs and animal products	5.5	4.7
Mineral products	2.2	21.7	Mineral products	0.4	8.6
Products of chemical industry	6.4	11.3	Products of chemical industry	5.2	8.2
Wood and wood articles	26.4	4.5	Wood and wood articles	32.0	3.6
Textiles and footwear	14.7	8.5	Textiles and footwear	15.1	5.8
Metals	7.9	6.4	Metals	10.0	4.1
Machinery	8.7	17.3	Machinery, transport vehicles	8.5	31.2
Other	18.0	20.1	Other	23.3	33.8
Total	100.0	100.0		100.0	100.0

Source: Latvijas Statistika, The Statistical Office of Latvia

Table 7. Lithuania's trade by groups of goods (percentage of exports or imports)

1994			1998		
	Exports	Imports		Exports	Imports
Live livestock and animal production	8.8	1.5	Live livestock and animal production	6.6	3.2
Foodstuffs	15.2	8.4	Foodstuffs	4.4	5.0
Mineral products	16.6	32.7	Mineral products	18.9	13.4
Production of chemical and related industries	10.6	8.7	Production of chemical and related industries	9.5	9.2
Wood and wood products	4.0	2.8	Wood and wood products	4.7	-
Textiles and footwear	13.3	7.8	Textiles	18.3	8.9
Metals	6.1	6.4	Metals	3.8	6.2
Machinery and transport vehicles	15.7	22.5	Machinery and transport vehicles	19.8	18.9
Other	9.7	9.2	Other	13.0	28.2
Total	100.0	100.0	Total	100.0	100.0

Source: Department of Statistics to the Government of the Republic of Lithuania

To conclude, at present, there are over 30 preferential trade agreements in force between the Baltic States and other countries. Moreover, many of the Baltic regional trade arrangements have been established with larger and geographically close countries. Over half of the Baltic foreign trade is focused on the European continent, the EU being the most important trade partner. The volume of trade has increased between the Baltic States and the Union, which could reflect the positive, trade-creating impact resulting from the preferential trade agreements between the parties. Inside the EU, some of the Union members are more active traders with the Baltic States than others. With regard to the composition of trade, exports from the Baltic States to the EU are currently dominated by wood, base metals, machinery and textiles. Imports from the Union consist mainly of machinery and technology. This outcome seems to be logical for transition economies which need new technology to raise output and export potential. Given the ongoing restructuring and the accession preparations for EU membership, the demand for investment goods in the Baltic countries is likely to remain in the future. Furthermore, in the long-run, as the differences in per capita GDP between the EU and the Baltic economies narrow, the share of intra-industry trade is likely to increase.

The Baltic countries' strong reorientation towards the West after the collapse of the Soviet Union and nearly ten years of political and economic cooperation with the EU, and especially the Baltic countries' current aspirations to become EU-members, reflect the importance of the EU to the Baltic countries. The EU is not only a significant trade partner, but also a European policy-maker which has influence over political and economic decision-making in the Baltic States. For this reason, the rest of this study will focus on the preferential trade relations of Estonia, Latvia and Lithuania with the EU. In particular, we will analyze the following questions. What role do preferential trade arrangements play in the EU enlargement process and the Baltic States' accession preparations? What are the sorts of preferential trade agreements - Association Agreements - in force between the EU and the individual Baltic countries? How have the Association Agreements contributed to trade liberalization over the years, and what is the degree of liberalization today? Do these preferential trading arrangements pose a threat to the WTO principles and the idea of multilateral trade liberalization?

PTAs as a Part of the European Union's Enlargement Process[47]

Chapter 3 concluded that the Baltic regional trade arrangements support the two hypothesis of new regionalism: the smaller Baltic States have preferential trade arrangements with larger countries, and these regional arrangements are also geographically regional. In this Chapter, it is argued that there are also other characteristics of new regionalism – small countries making significant unilateral reforms and regional arrangements involving deep integration – which apply to the preferential trade arrangements between the Baltic States and the EU.

In June 1997 the Amsterdam European Council called for accession negotiations to begin in 1998. One month later, the Commission published its Agenda 2000 document and *opinions (avis)* on each applicant's ability to accept the body of EU-law *(acquis communautaire)*. The December 1997 Luxembourg Council decided that negotiations should be started with five Central and Eastern European countries and Cyprus, and with another five countries when they have made the necessary progress required for accession.Negotiations finally began on 30 March 1998 with the first wave of six countries: Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia. These will be followed by a second wave of five countries: Bulgaria, Latvia, Lithuania, Romania and Slovakia.

Enlargement is a complex and challenging issue. Much of the work to make enlargement possible is being done within the candidate countries themselves. Their economies must succeed in closing the development gap with respect to the EU, carry out transition to a market economy and revise their national legislation. This applies to the Baltic States as well as to the other Central and Eastern European countries.

In general, markets already function reasonably well in the most candidate countries. They have liberalised most prices and external trade. Furthermore, most of the restrictions on entry for new companies have been removed and currency arrangements have been liberalised. Reforms have been implemented in the financial sector and subsidies have been eliminated. Many countries have also completed privatisation of small-scale enterprises and progress has been made in privatising larger enterprises. However, in several areas of economic activity, effective and transparent corporate governance and appropriate standards for conducting business still have a long way to go. This applies, in particular, to enterprise restructuring, the strengthening of financial institutions, commercialisation of infrastructure and environmental protection. In addition, since the Central and Eastern European countries want to become EU members, their legal restructuring must take into account demands of the internal market of the Union. The reform of the civil, trade, and economic codes, aiming at the adjustment to a market economy, is pushed forward in all countries.

From the Union's side, the *accession strategy* is based mainly on five elements:

1. *Association Agreements (Europe Agreements)* on economic co-operation;
2. The *White Paper* on approximation of laws;
3. The *PHARE programme* of economic aid to the associated countries;
4. *Structured dialogue* consisting of meetings of heads of state and government and ministerial meetings; and
5. The *accession partnerships*[48] forming the keystone of the whole accession strategy.

As a stepping-stone to membership, and in order to boost trade between the Community and the CEECs, the EU has signed Association Agreements - Europe Agreements - with each individual Central and Eastern European Country. Apart from Slovenia, ratification has been completed and the agreements are in force. They acknowledge the interest of a partner country in becoming a full member of the EU. Moreover, they are *preferential agreements* designed to establish a close, long-term association between the EU and individual CEECs. The driving goal for the Association Agreements is to create a climate of mutual confidence necessary to the demands of the internal market and stability favouring political and economic reform in the CEECs. Furthermore, partners in Central and Eastern Europe should be enabled to participate in a wider process of European integration. The objective of the Association Agreements is to establish a free trade area by the year 2002, liberalising trade in industrial products and providing a basis for economic co-operation in a large number of sectors. In addition, parties shall try to encourage a climate for trade and investment, improve the transparency of Community financial support and promote a two-way flow of information and co-operation. At a practical level, the above-mentioned objectives have appeared in intensifying political dialogue, removing of trade barriers (customs duties, quantitative restrictions and measures having equivalent effect) and the gradual harmonisation of principles covering the movement of workers, establishment of firms and supply of services. Concrete actions have also included liberalisation of payments and capital as well as harmonisation of competition policies. Finally, the agreements call for improvement of protection of intellectual, industrial and commercial property rights and approximation of legislation to that of the Community.

The multidimensional feature of the Association Agreements supports our working hypothesis: regional arrangements between the Baltic States and the EU (as well as between other CEECs and the EU) involve deep integration and significant reform efforts from the candidate countries. Despite the multi-level and multi-type characteristics of these agreements, the next part of the study will focus only on the progress in trade liberalization in industrial and agricultural goods between the EU and the Baltic States, origin rules as well as some of the other commercial policy measures laid down in the Association Agreements.

Association Agreements between the EU and the Baltic States: How Liberal?

When we analyze the preferential trade arrangements between the EU and other countries, the first important point to be made is that there is not a standard form of preferential trade agreement with the EU.[49] While agreements often cover most or all of industrial goods, some products, i.e. textiles and clothing, coal and steel have been, or still are, subject to special quotas. In addition, liberalization is asymmetric and transition periods vary. With regard to trade in agriculture, access to the EU markets is often selective, product-based and well protected.[50] These fundamental characteristics apply also to the preferential trade agreements between the EU and the Baltic States.

At the beginning of 1995, Free Trade Agreements between the EU and the Baltic States entered into force. In February 1998, the Free Trade Agreements were replaced by the Association Agreements, which the Baltic countries had signed already in June 1995.[51] However, as far as trade in goods is concerned, the Association Agreements neither altered nor added to the provisions of the FTAs already concluded. Negotiations begun on 30 March 1998 with the first wave of six countries: Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia. Finally, on 13 October 1999, in its regular report on progress towards accession by each of the candidate countries, the Commission proposed that accession negotiations should be opened also with the remaining candidate countries: Bulgaria, Latvia, Lithuania, Romania and Slovakia.

According to the Association Agreements between the Community and individual Baltic States, a free trade area will be established in transitional periods lasting maximum of four (Estonia and Latvia) to six (Lithuania) years.[52] In addition, the aim is to create a free trade area in conformity with the principles of the GATT and the WTO.[53] The standstill clause, which is an important element of these agreements, rejects any increase in protection starting from the day before the entry of the agreement (1 January 1995). In other words, the duties in force earlier constitute the basis of the agreement.[54] As regards to industrial goods, the Association Agreements divide them into three groups: 1) textiles and clothing, 2) coal and steel products, and 3) other industrial products. The first two groups are often referred as the Community's sensitive sectors. As far as textiles and clothing products are concerned, the Association Agreements originally covered only customs duties. Quantitative restrictions were dealt with the separate Textiles Protocol. However, since the beginning of 1998, all quantitative restrictions as well as the other restrictive measures have been abolished on imports of textiles and clothes into the EU.[55] With regard to trade in steel products, quantitative restrictions were abolished from the entry of the Baltic-EU Association Agreements (February 1998). Customs duties on steel products were eliminated for all associated countries already on 1 January 1996. Regarding coal and related products, both customs duties and quantitative restrictions were fully eliminated by the beginning of 1996.

At present, Estonia maintains one of the most liberal trade regimes in the world.[56] Tariffs, quantitative restrictions and other protectionist measures have largely been abolished and trade-related subsidies are limited mainly to the agricultural sector. No tariffs except for furs, motorcycles, cycles and recreational boats are being applied.[57] In addition, export duties are applied only on objects of cultural value. Estonia's liberal foreign trade regime has also contributed to the very liberal trade between Estonia and the EU. Customs duties and quantitative restrictions for industrial products were abolished from the beginning of 1995, on entry into force of the FTA.[58] Respectively, no customs duties or quantitative restrictions are presently applied for industrial products traded between Latvia and the EU.[59] In EU-Lithuania trade, quantitative restrictions for industrial products have been abolished since the beginning of 1995. However, Lithuania still applies customs duties on some industrial goods, but these will be progressively eliminated by 1 January 2001.[60]

Unlike in of the regulations of industrial products, the Association Agreements do not provide very liberal trade in agricultural or processed agricultural goods. Concessions are used but none of them significantly liberalize trade. In general, the tariff concessions only apply on a quota with the quantity rising by 10% each year over a five-year period. If concessions granted by the agreements seem to result in a serious disturbance in the markets of the partner country, the "suffering" party can adopt measures to restrict imports. When one compares agricultural trade arrangements between the EU and individual Baltic countries, Estonia makes a clear exception in terms of the degree of liberalization: it has fully liberalized market access, whereas the EU has offered so called 'selective liberalization' for products of Estonian origin. Concessions either with unlimited access or in the framework of tariff quotas are used. No quantitative restrictions are applied to agricultural imports into the Community or to imports into Estonia.[61] The liberal attitude towards agricultural imports in Estonia has recently been challenged, especially after the outbreak of the Russian economic crisis in August 1998 which negatively affected Estonian food exporters.[62]

With respect to agricultural trade arrangements between the Community and Latvia, and the Community and Lithuania, no quantitative restrictions are applied. Concessions on reciprocal basis are used.[63] Higher tariffs are applied in particular on processed products like sugar and butter.

Since July 1996, the Association Agreements have been modified to take into account the Agreement on Agriculture concluded during the GATT Uruguay Round, and also to reflect further improvements in the concessions on agricultural products granted to the Baltic States.[64] The GATT related adjustments, together with new concessions decided by the Community, have increased the preference level for all agricultural products from 60% to 80%. Furthermore, the general applicable duty has decreased from 40% to 20%.[65]

In addition to the restrictions still applied to trade in agricultural products, the Association Agreements contain various contingent commercial policy instruments, namely a general safeguard clause, an anti-dumping clause, export safeguards, a special safeguard clause, and anti-subsidy measures. The main idea behind these instruments is that they provide the possibility to deviate from a trade liberalization agreement when a party's interests are affected. This includes, for example, situations where the increase in imports causes or threatens to cause significant damages to domestic producers (goods and services) and/or in a particular sector of economic activity or region. The same applies to exports in cases of serious shortages. An anti-dumping clause gives the right to penalize products which are being sold in the receiver's market at a lower price than they are sold on the trade partner's own market. The anti-subsidy measure functions similarly, but it is applied when a foreign competitor is receiving state subsidies. Finally, the specific safeguard clause is addressed to the association countries; in the case of infant industries, sectors under restructuring or sectors facing other serious difficulties have the right to adopt protectionist measures against the imports coming from the Union. Exceptional duties are usually in the form of increased customs duties.

Rules of origin are important in implementing trade policy instruments, such as anti-dumping and safeguard measures. The EU has general origin rules, which are applied to MFN trade. These rules also conform with the WTO rules following from the GATT 1994 agreement.[66] However, these WTO rules do not apply to preferential trade agreements, such as the Association Agreements. In the EU's preferential trade arrangements, "substantial transformation" and "sufficient working or processing" serve as a general foundation for the determination of the rules of origin.[67] According to the most common rule applied in the Association Agreements, 60 percent of the value of the product must be derived from the value added in the associated country. However, the rules of origin applied in the EU's MFN trade have been less stringent than origin rules under preferential trade agreements.[68] Depending on the results of the ongoing harmonization process of origin rules, both inside the EU and within the WTO framework, some improvements are likely to result in the future. Since the beginning of 1997, the Baltic countries, as well as the other CEECs and EFTA States, have all been covered by "pan-European cumulation of origin", in which the origin of products can be moved around while still qualifying for preferential tariff treatment.[69]

Chapter 2 introduced some of the general themes of old and new regionalism. Chapters 3-5 analyzed the applicability of six specific hypotheses of new regionalism in preferential trade relations between the EU and the Baltic States. In the following discussion, we shall return to the more general but fundamental question of new regionalism: whether preferential trade arrangements hinder or promote multilateral trade liberalization initiatives. Indeed, slow liberalization in agricultural trade, the commercial policy measures, as well as various other provisions in the Association Agreements, have sometimes been criticized for hindering further trade liberalization efforts rather than promoting them. Whether or not this critique is justified is the topic of the next Chapter.

PTAs, WTO and the Multilateral Trade System

WTO and Preferential Trade Arrangements

The multilateral trading system of the General Agreement on Tariffs and Trade (GATT) has, no doubt, played a crucial role in worldwide trade liberalization process. It has been the promoter in reducing trade barriers worldwide (see Table 8). So far there have been eight rounds of trade negotiations, the latest being the Uruguay Round (see Table 9). As a result of the Uruguay Round, the

World Trade Organization (WTO) was established in 1995. Perhaps the most significant issue related to the creation of the WTO was that, for the first time in GATT's history, a forum for the settlement of trade disputes was created.[70] In addition, the WTO provides a single institutional framework encompassing GATT as modified by the Uruguay Round, and the results of the Uruguay Round.[71] The main principle followed by GATT/WTO in international trade relations has been the 'most favored nation' treatment (MFN) (Article I). According to this rule, any advantage in terms of trade policy applied to another country must be applied, immediately and unconditionally, in the same way to all other GATT/WTO contracting parties.[72] Discrimination against imports from a particular country/countries is prohibited. True, this MFN principle is applied only to GATT/WTO members and therefore falls short of being worldwide. However, membership in the organization is open to all countries that meet the criteria for admission. Another core principle of GATT/WTO is that of reciprocity, according to which the mutual changes in trade policy should result in equal changes in import volumes across trading partners. Finally, the principle of national treatment (Article III) calls for the equal treatment of nationals and foreigners as regards to regulations and/or commercial policy measures. From a regional point of view, an important notification is that the GATT makes provision for certain exceptions to the MFN-rule. The best known is the Article XXIV, which allows countries to establish preferential trading areas: free trade areas and customs unions. For example, regional blocks, such as the European Union, are indeed considered consistent with the WTO/GATT, although they can pose a threat to its basic conception of the world trading system. In addition, PTAs including partial preferences are allowed for developing countries. A third exception where PTAs are allowed is within the Generalized System of Preferences (GSP), according to which developed countries can grant trade preferences to developing countries. All in all, the principal requirement is that the purpose of a regional trade agreement should be to facilitate trade between the constituent territories, not to raise barriers to the trade of other WTO Members which are not parties to the agreement.[73]

Referring to trade theory, argument along the lines of Article XXIV has been presented by Bhagwati and Panagariya (1996). They find justification for PTAs only on two occasions. First, when a group of countries aims at deep economic and political integration including capital and labor mobility and uniform policies in various fields and, second, when the PTA is set using the multilateral trade negotiations approach under GATT/WTO and according to the Article XXIV.[74] Nevertheless, while making two justifications for PTAs, the authors do express their concern about whether policy makers can really differentiate between free trade and free trade areas. In addition, it is asked whether an increasing number of PTAs will actually be formed in harmony with the WTO principles, and finally, whether Article XXIV could be so strengthened as to ensure that its discipline is respected by member states.

Table 8. Estimated Real Income Effects of the Uruguay Round[75]

Study and Assumptions	Industrial Countries	World
GATT Secretariat[76]	European Union $98 billion North America $67 billion	$230 billion
OECD[77]	Australia and New Zealand $185 billion Canada $6.6 billion European Union $71.3 billion EFTA $38.4 billion Japan $42.0 billion United States $27.6 billion	$274.1 billion

Source: IMF, World Economic and Financial Surveys-World Economic Outlook (May1994)

Table 9.GATT Negotiations Rounds

Round	Time[78]	Number of Negotiating Countries
Geneva	1947	23
Annecy	1949	33
Torquay	1950	34
Geneva	1956	22
Dillon	1961	45
Kennedy	1962	48
Tokyo	1973	99
Uruguay	1986	107

Source: OECD (1992), Bhagwati (1991)

Association Agreements: for or against the WTO principles?

In principle, the Association Agreements are not bound by the WTO principles. They aim at providing preferential treatment over other third countries in trade with the EU. To what extent are/are not these PTAs between the EU and the Baltic States in line with the rules of the WTO and with the idea of multilateral liberalization of trade? Several concerns are worth discussing, some of them have been raised on a general level, especially on the part of the WTO members.

In particular, the special treatment that has been applied to agriculture and earlier also to textiles have been under extensive discussion during the trade policy examination sessions in the WTO. For example, the EU is maintaining (has maintained) protectionist measures in sectors, in which the Baltic countries (and other Central and Eastern European countries) could be expected to have some comparative advantage. This can have significant implications on economic growth in these countries. In addition, it has been asked whether the preferential agreements would raise trade barriers to third countries and also what their consequent economic effects are. There have also been concerns about the systemic effects of the preferential trade agreements on multilateral trading system. Finally, one can ask how different commercial policy instruments have affected on the ultimate motive of preventing new protection and abolishing the existing trade barriers.

First, it should be noted that no sectors have been excluded from the coverage in the Association Agreements. In other words, the aim of "substantially all trade" has been achieved. Nevertheless, changes in the composition of the EU-Baltic trade partly reflect the progress in liberalization in different sectors. For example, increase in trade of manufactured products between Estonia and the EU and also between Lithuania and the EU could partly be explained by further liberalization of trade in industrial products. Similarily, the share of textiles in foreign trade between the EU and the Baltic countries did not change dramatically during the period of 1993 till 1998, which could partly indicate the EU's protectionist trade policy in this sector at the time. As regards the agricultural sector, the EU has indicated that at the end of the transition period, the only sectors where there might still remain some protective measures would be agriculture and fisheries.[79] At this point, it should be noted that with the ongoing discussion on the Community's agricultural policy and the WTO negotiations to begin at the end of this year, the Community's agricultural policy remains a moving target. Nevertheless, as was already mentioned, the GATT-related adjustments, together with the additional concessions decided by the Community, have so far increased the preference level for all agricultural products and lowered the general applicable duty. If one of the Baltics' future comparative advantages lies in processed agricultural goods, the EU's protectionist policy, if continued, could hamper the exploitation of this advantage in the EU markets. In addition, given the fact that the Baltic States constitute only a marginal share of the EU's foreign trade, it is difficult to see justification for remaining protection. However, this trade is largely surplus trade for the EU and therefore, in itself, adds to the Community's protectionist attitude. Moreover, it should be remembered that if the EU would open its agricultural trade with the Baltic States, it would be under political pressure to do so with the other Central and Eastern European associated countries as well. Consequently, the whole issue would no longer be marginal in nature.

Furthermore, a part of the access problem related to agriculture has to do with the Baltic States' own difficulties in complying with EU import requirements.[80] Overall, it seems that liberalization has been lower and the protection is likely to remain for some of the products that constitute the exportable goods and future exportable goods for the Baltic economies. This naturally has some implications on the Baltic countries' possibilities for increasing exports.[81]

One important point, which is also along the lines of the WTO principles, is that since the formation of the FTAs (and later the Association Agreements), neither the EU nor the Baltic partners have raised their tariffs, imposed new quantitative restrictions or other restrictions. Deviation incentives from this principle have been observed only recently and they have mainly been related to the agricultural sector.[82]

Regarding rules of origin, the Association Agreements, in principle, aim to provide for full cumulation across the agreements in order to reach a simple and transparent system in the overall pre-accession context. The recent changes in rules of origin are related to the harmonization of these rules among European countries and the establishment of a single territory for the determination of origin between the EU, EFTA and the Central and Eastern European countries.[83] As is the case with agricultural liberalization, rules of origin remain also a moving target due to the ongoing harmonization process. Moreover, there have been various practical difficulties with introducing full cumulation.[84] Despite these problems, further efforts to promote the cumulation of rules of origin should be encouraged. After all, they play a crucial role in developing regional trade and creating new business possibilities. The same applies even though some of the market access problems related to origin rules are likely to become less significant as the non-agricultural tariffs of the EU approach to very low levels or zero. From the point of view of the Baltic countries (as well as the other associated countries), another interesting observation to be made is that the EU's rules of origin have been/are stricter under preferential trade agreements than the rules of origin generally applied to the Union's MFN trade.[85] Consequently, although customs duties are lower under preferential trade agreements, it has been/is still more difficult to obtain origin under the Associated Agreements than under MFN trade. It would be difficult to estimate how much the Baltic States have been influenced by these "unequal"origin rules. Nevertheless, as a policy recommendation it would seem natural to support the idea of harmonization (and simplification) of rules of origin between the EU's preferential and non-preferential agreements.[86] All in all, while rules of origin are often considered to be purely technical arrangements, their power as an important part of commercial policy deserves continuous attention. Rules of origin should not themselves create restrictive or distorting effects on trade.

Whether various safeguards, anti-dumping and anti-subsidy measures in the Association Agreements work aginst the ultimate goal of trade liberalization greatly depends on how easily these measures could have been/can be adopted and for how long they can be maintained. As regards to the duration of these protectionist measures, the Agreements state that they cannot be applied for a period longer than two to three years (unless otherwise agreed with the Association Council).[87] However, all measures must be terminated when conditions no longer justify their maintenance, and at the latest by the end of the transition period. Furthermore, none of the measures can be used in sectors where duties or quantitative restrictions were removed more than three years ago. One of the weak points related to the commercial policy instruments is that both parties can (and have been able to) implement measures with relatively short notice; within 30 days or in some extreme cases even immediately. Moreover, they can be imposed without too much procedure. A special safeguard concerning protectionist rights of the associated countries is a good example. Even if no consensus is reached during the consultations between the Community and the Association Council, the associated country can adopt additional measures without the Community's approval. The only requirement is that the associated country has to submit a plan for phasing them out. Moreover, the schedule shall apply for a phasing of these duties two years after their introduction, at the latest.[88] The possibility of increasing protection by using some of the above mentioned measures is gradually becoming limited as the transition periods for industrial trade liberalization with Estonia and Latvia have already ended and the transition period in Lithuania's case will end by 2001.

So far only a few anti-dumping cases have been raised by the EU against the Baltic States and at present, there are three definitive anti-dumping measures in force, one against each Baltic country.[89] Moreover, the scope of dumping penalties laid on the Central and Eastern European associated countries as a whole has been low.[90] Despite this, the EU's anti-dumping regulations and procedures still seem to give cause for criticism. Among others, the degree of secrecy, the calculation methods, and underestimating the importance of the market structure when measuring injury have been the most criticised elements. In addition, although the actual number of anti-dumping penalties has been relatively low, there are other less obvious but nevertheless significant effects that may cause problems to the associated countries in the long-run. Namely, that anti-dumping charges can harm the credibility of market reforms and thereby also harm the confidence of investors. At the end, this might cause injuries in sectors, which are crucial for economic growth in that country. All in all, safeguards, anti-dumping and other similar defence measures in the Association Agreements can be not considered as the most effective tools for encouraging further trade liberalization. This, to some extent, also justifies concerns about the possibility of reverse trade liberalization.

Another interesting aspect related not only to the Baltic-EU preferential trade arrangements, but the Association Agreements in general, is the so called hub-and-spoke criticism presented by Richard Baldwin.[91] The main idea behind the argument is that when there is a hub, such as the EU, that dominates the economic activity of a certain region and has bilateral trade arrangements with peripheral associate countries which themselves have no free trade, the location of economic activity is likely to concentrate on the hub. This is because firms located in the EU can export freely (at the end of the transition period) within the Union or into the associated countries. However, if these firms were located in an associated country, they could trade freely with the EU but not necessarily with the other associated countries. With regard to the Baltic region alone, Estonia, Latvia and Lithuania already have industrial and agricultural free trade agreements with each other. However, as was mentioned earlier, their competitive (rather than complementary) trade structures with each other contributes to the hub-and-spoke phenomenon. The hub-and-spoke issue becomes even more relevant when one looks at the whole club of associated countries, among which there is no full free trade. In this respect, the development and enlargement of the CEFTA – Central and Eastern European Free Trade Area- plays a significant role.[92]

Conclusions

The purpose of this study was to analyze the preferential trade arrangements between the Baltic States and the European Union. Theory on regionalism constituted the basis of the study and was used to explain some of the static and dynamic effects related to preferential trade arrangements. In addition, the six specific hypotheses of new regionalism were applied to the Association Agreements between the Baltic countries and the EU.

The preferential trade arrangements between the Community and each individual Baltic State have characteristics of the new regionalism: reform-minded small countries, Estonia, Latvia and Lithuania, are linking with a large neighbor, the EU. This involves significant unilateral reforms in the Baltic countries in order to be accepted into the EU. In addition, regional integration involves deep integration, from free trade to a common market and harmonized rules and policies, but confers relatively minor trade advantages as most of the bilateral trade has either already been liberalized or remains protected on sensitivity grounds.

During the last decade the European Union's Single Market Program and liberalization according to the WTO principles have improved access conditions for the EU's trading partners. There seems to be a general understanding on the EU side that strengthening European Union integration both in the Single

Market and through the regional and bilateral agreements are likely to have increasing effects on the outside world, and on the multilateral system as a whole. This applies not only to the extension of duty-free access on an FTA basis, but also through the adoption of the EU's trading regime by its partners. While the EU is bound by the WTO principles and these rules have had an influence over the EU's policy making, criticism is justified in some respects.

The analysis of the Association Agreements between the Community and the Baltic States shows that while the EU has played a significant role in opening up the EU market for the Baltic industrial products, more can be demanded in terms of liberalization in the agricultural trade. In particular, given the fact that agriculture is suggested to represent one of the future comparative advantages for the Baltic States, and that the Baltic countries constitute only a marginal share of the EU's overall foreign trade, it is difficult to see justification for protection remaining. However, the Union's trade with the Baltic economies is mainly surplus trade, which adds to protectionist attitudes within the Community. Moreover, if the EU opened up its agricultural trade with the Baltic States, it would be under political pressure to do so with the other Central and Eastern European associated countries as well. Consequently, the whole issue would no longer be marginal in nature. Given the current efforts to reform the Community's agricultural policy and the WTO negotiations to begin at the end of this year, the level of agricultural protection, future concessions, and the Union's agricultural policy as a whole will remain dynamic.

When it comes to commercial policy measures — the special safeguard clauses, anti-dumping and anti-subsidy regulations – the Association Agreements provide an opportunity to deviate from liberalization and can therefore be seen as possible obstacles for further trade liberalization initiatives. Part of this risk is, however, gradually being reduced as the transition periods come to an end, limiting the possibilities to use these measures.

The Community's system of 'origin rules' is currently being harmonized with the aim of establishing a single territory for the determination of origin between the EU, EFTA and the CEECs. This, together with the harmonization of rules of origin within the WTO framework are likely to improve the inequality in the Association Agreements, namely that the origin rules have been stricter under the preferential agreements than under the EU's MFN trade. In addition, the access problems related to origin rules are likely to become less important to the Baltic exporters, especially in the non-agricultural sectors, because the tariff margins (preferential and MFN) are already low or approaching zero.

Finally, it can be concluded that in order to assure the compliance of the European Union's trade policy with the WTO principles, monitoring of both the Community's existing, as well as possible new, preferential trade arrangements remains significant.

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and Business Administration

Annex 1. Overview of the European Union's Trade Policy

During the last decade, the European Union's Single Market Program and liberalization according to the WTO principles have improved access conditions for the EU's trading partners.[93] Overall, the EU's external trade policy can generally be characterized as a combination of bilateral, regional and multilateral policies. While many of the EU's trading partners enjoy free trade area or other preferential treatment, most of the imports still enter into the EU at MFN (most-favored-nation) rates.[94] So far, manufacturing has benefited most from continued reductions in tariff and non-tariff barriers. Average MFN tariffs on industrial goods have fallen from 6 percent in 1995 to 4.9 percent in 1997. Further reductions, as part of the Uruguay Round, will result in an average MFN tariff for industrial products under 3 percent at the turn of the century.[95] In agricultural sector, average rates are still higher, but nonetheless have been reduced from 25 percent in 1995 to 20.8 percent 1997.[96] Protection measures also remain significant in some of the sensitive industrial sectors such as textiles, automobiles and consumer electronics. However, as a result of WTO Agreements and under bilateral arrangements, most of the restrictions concerning the sensitive products will be abolished at the turn of the century, or shortly thereafter. The liberalization of services trade and harmonization of standards has proceeded steadily, but significantly slower than, for example, liberalization of industrial trade. Nevertheless, service sector is becoming more important and the removal of restrictions, both externally as well as within the Single Market has therefore become one of the EU's main policy objectives. Indeed, the EU has been very active in promoting GATS[97] negotiations. When it comes to the overall nature of protection in the EU, the border protection is gradually being reduced, while more attention is being drawn to internal obstacles to trade, such as competitiveness and more efficient resource allocation. In recent years, there has been an increase in the number of competition policy cases, which have contributed to the EU's growing interest in developing competition policies at the multilateral level. Compared to international standards, government assistance to the EU economy has been significant. This applies especially to agriculture and services. With regard to the Community's Common Agricultural Policy, the Commission's Agenda 2000 communication of July 1997 and the policy reforms proposed in the Agenda 2000 in March 1998 indicate that farm subsidies as well as other regulations of the Community's agricultural policy will require changes. Some of the suggested reforms include the adoption of more market-oriented measures with less support on price mechanisms and export subsidies, less intervention and a shift towards direct income support.[98] In terms of anti-dumping, the EU still remains an important user of anti-dumping procedures. Current challenges in rules of origin deal with the harmonization of these rules among European countries. With regard to preferential trade agreements, the EU has underlined the fact that these agreements should be in line with and support the multilateral trading system and worldwide liberalization of trade barriers.[99]

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Endnotes

[1] GNP measured at PPP (purchasing power parity): The World Bank, World Development Report 1998/99.
[2] Wilfred Ethier (1998): The New Regionalism. The Economic Journal, 108 (July): 1149-1161.
[3] Lahiri Sajal (1998), Contrversy: Regionalism versus Multilateralism. The Economic Journal, 108, July. 1126-1127.
[4] Bhagwati (1991), The World Trading System at Risk. Harvester Wheatsheaf. 3-79.
[5] Sapir Andre (1998), Trade Regionalism in Europe: Towards and Integrated Approach. 2-4.
[6] 89 of these RTAs are bilateral agreements, and 82 of these bilateral agreements are free trade agreements (FTAs). In addition, 74 of the FTAs involve Central and Eastern European Countries (CEECs).
[7] WTO (1999): http://www.wto.org. Regionalism and Multilateral Trading System.
[8] The phrase comes from Wonnacott and Lutz (1989).
[9] Deardorff (1998).
[10] See, for example: Meade (1955), Lipsey (1970).
[11] Bhagwati and Panagariya (1996).
[12] Frankel (1998): The Regionalization of the World Economy. National Bureau of Economic Research, London: p.106-107.
[13] Bhagwati (1996).
[14] Ethier (1998).
[15] Baldwin (1997).
[16] At the end of 1998, the Committee on Regional Trade Agreements of the WTO started to examine 62 regional trade agreements, including the European Community's free trade agreements with various Central and Eastern European Countries, the North American Free Trade Agreement NAFTA, the Central European Free trade Agreement CEFTA etc. The Committee will address especially the systemic implications of these agreements and the repercussions such agreements may have on the functioning of the WTO system of rights and obligations.
[17] Baldwin (1989).
[18] The degree of external scale economies = divergence between the social and private marginal productivity of capital. Bagwell and Staiger (1997). p.10-19.
[19] See: Bhagwati (1991, 1993), and Bhagwati, Greenway & Panagariya (1998).
[20] In the study, it is argued that GATT's principles of reciprocity can lead to a neutralization of the world-price effects of a country's trade policy decisions, and therefore can deliver efficient trade-policy outcomes for its members. This favorable outcome, however, requires that the externalities associated with the trade intervention travel through world prices. The externalities, in turn, travel this way if and only if tariffs also conform to the principle of non-discrimination (MFN). Following this kind of path, the principles of reciprocity and non-discrimination can work together and result in efficient outcomes for the multilateral trading system.
[21] The principle of reciprocity will be discussed more in section 6.1.
[22] Baldwin (1993 & 1997).
[23] Baldwin (1997).
[24] Levy (1994).
[25] Krishna (1995).
[26] DeRosa (1998).
[27] Baldwin (1997).

[28] The study by Winters & Won Chang (1997) measures the welfare effects of regional integration on the terms of trade. They show how Spanish accession to the EU affected the prices of imports from the EU, Japan and the United States. One of the conclusions made is that non-members (Japan and the USA) suffered significant losses in terms of trade relative to European Community competitors in Spanish import markets for differentiated goods.
[29] The European Commission: Regular Report from the Commission on Estonia' s Progress Towards Accession. November (1998).
The agreements have been in force since 1 January 1999. Estonian Economy 1998-1999. Republic of Estonia, Ministry of Economic Affairs. Tallinn (1999): p.129.

[30] Edward Elgar and Laxenburg (1997): Latvia: Trade Growth in Transition Economies. Export Impediments for Central and Eastern Europe. IIASA, p.118.
[31] The European Commission: Regular Report from the Commission on Latvias's Progress Towards Accession. November 1998.
[32] The European Commission: Regular Report from the Commission on Lithuania's Progress Towards Accession. November 1998.
[33] Agreements notified under GATT Article XXIV.
[34] FTA (Free Trade Area)
[35] BFTA (Baltic Free Trade Area consisting of Estonia, Latvia and Lithuania)
[36] EFTA (European Free Trade Association; current members: Iceland, Liechtenstein, Norway and Switzerland)
[37] Cze (Czeck Republic), Slk (Slovakia), Slo (Slovania), Pol (Poland), Tky (Turkey), Hun (Hungary), Ukr (Ukraine).
[38] It should be noted that the Baltic trade statistics vary. There are differences depending on the source of statistical data. In addition, some of the earlier national statistics have later been corrected. There are also differences between countries in terms of collection of country- and product based trade data. Due to the limitations regarding to quality and quantity of the Baltic trade statistics, conclusions should be dealt with caution.
[39] This finding can most likely be explained both by geographical as well as historical reasons.
[40] See the discussion on the composition of trade. 14-16.
[41] Mayhew (1998). 89.
[42] On intra-Baltic integration, see: Viplisaukas (forthcoming, 1999).
[43] In 1993, the share of the EU as one trading partner was not registered in Lithuanian national statistics.
[44] Country specific data on the composition of trade flows is not collected for each country. In this study, information concerning the trade structure with the EU is based on the Eurostat statistics, the EU Commission Opinion and trade statistics provided by the Baltic National Statistical Offices.
[45] Observations are based on the trade statistics provided by the Baltic statistical offices. For more detailed analysis of trade between the Baltic States and the European Union, see: Kaitila &Widgren, forthcoming in 1999.
[46] See the conclusions of Kaitila & Widgren (1999). 26-29.
[47] With regard to the likely effects of the CEECs joining the European Union, see: Baldwin, Francois and Portes (1997), 125-76. The article reviews some of the main cost-benefit calculations on enlargement.
[48] The accession partnerships were launched on 15 March 1998 and include three basic components:
1) priority areas in which the Community legislation (acquis) is to be adopted,

2) programming for the Union's financial assistance,
3) terms applying to this aid; compliance with the obligations under the Association Agreements and progress in meeting the Copenhagen criteria.

[49] Annex 1 presents an overview of the European Union's trade policy.

[50] World Trade Organization. http://www.wto.org: Policy Reviews (1997), Pelkmans & Brenton (1997)

[51] These agreements were notified under the Article XXIV of the GATT in June 1995. Finnish Ministry of Foreign Affairs. EU Secretariat. NL 1/1999.

[52] These transitional periods apply starting from the entry into force of the Agreement of Free Trade and Trade Related Matters: on 1 January 1995.

[53] Europe Agreements.

[54] For Estonia, the basic duty for each product covered by the Association Agreement was that applied on January 1994 (Article 8). In case of Latvia, the basic duties, with few exceptions, were mainly those applied on January 1995 (Article 8). For Lithuania, the basic duty, depending on the product, was that applied either on March 1994, or January 1995 (Article 8).

[55] Mayhew (1998). 63.

[56] In 1998, the foreign trade turnover of goods and services amounted to 168 % of the GDP (166% in 1997) in Estonia. There are only a few countries in the world with a so open economy where the foreign turnover of goods and services exceeds the GDP to such an extent. Bank of Estonia, Newsletter N1(200) 20.3.1999.

[57] The European Commission: Regular Report from the Commission on Estonia's Progress Towards Accession. November, 1998.

[58] Europe Agreement between the European Community and Estonia, Document 298A0309(01): Articles 9-16., Mayhew (1998).

[59] Europe Agreement between the European Community and Latvia, Document 298A0202(01): Article 9-17., Mayhew (1998).

[60] Europe Agreements between the European Community and Lithuania, Document 298A0220(01):
Article 9-17. Industrial products on which customs duties still apply, see Annex II, III, IV and V. Mayhew (1998).

[61] Europe Agreement between the European Community and Estonia, Document 298A0309(01):
Articles 17-20. Agenda 2000, Commission Opinion (1997).

[62] Bank of Finland, Institute for Economies in Transition, Russian and Baltic Economies 4/1999.

[63] Europe Agreement between the European Community and Latvia, Document 298A0202(01): Article 18-21. Europe Agreements between the European Community and Lithuania, Document 298A0220(01): Article 18-21.

[64] The European Commission:http://europa.eu.int. Policies. Free Trade and Association Agreements with the EU. 1997.

[65] The European Commission:http://europa.eu.int. Policies. Free Trade and Association Agreements with the EU.1997.

[66] Article IX.

[67] The European Commission. 1998. Comm(98)0389 final. Rules of origin defined in the context of preferential arrangements.

[68] 1) Community Legislation Doc. 394D0800"Relations in the Context of the General Agreement on Tariffs and Trade". 2) The Europe Agreements between the EU and Estonia, Latvia and Lithuania.

[69] The EU Commission; Community policies; External Relations.

[70] The recent EU-US dispute over bananas and beef have clearly shown the usefulness of such a dispute settlement system as well as difficulties associated with it.
[71] See more: IMF, World Economic Outlook (1994). The Uruguay Round: the main results and implications.
[72] OECD (1992)
[73] WTO. http://www.wto.org. Regionalism and the Multilateral Trading System.
[74] WTO. http://www.wto.org
[75] These estimates were under criticism at the time. Nevertheless, they give, if nothing more, at least some indication about the results of the Uruguay Round.
[76] Trade liberalization was based on the market access offers as of November 19, 1993;liberalization of tariff equivalents of Multi-fibre Agreement Quotas; 20 percent cuts in tariff equivalents of agricultural production subsidies; and 36 percent cuts in tariff equivalents of agricultural border measures. Includes gains from induced capital accumulation. Gains were measures in 2005, expressed in 1992 dollars.
[77] Tariffs and ad valorem equivalent non tariff barriers (NTBs)were reduced by 36 percent in manufactures, agricultural goods, and other imported goods. Information on tariffs and NTBs at the tariff line level were utilized. Gains were measured in 2002, expressed in 1992 dollars and as a percent of GDP.
[78] Time refers to the year when the negotiations were launched.
[79] WTO. http://www.wto.org: "Policy Reviews. Examination of the Free Trade Agreements between the European Communities and Estonia, Latvia, and Lithuania" (1997).
[80] For example, in terms of recent concession granted to Latvia, since January 1998 six dairy processing establishments have been licensed to export to the EU. However, as of July 1998, no Latvian slaughterhouse has received the authorisation for exports to the EU, which is important given the fact that the Latvia's exports potential to the EU lies partly in meat and dairy products. The European Commission. 1999.
[81] Similar conclusions concerning the effects of the Association Agreements has been made also in case of other CEECs (Schulz, 1995).
[82] For example, at the beginning of March this year, the Lithuanian government announced a decision to change the tax valuation of imported agricultural goods. The purpose of this measure is to modify the valuation of goods so that they correspond to the real market values. Lithuania plans to apply the measure until 2000. (Baltic News Service, 9.3.1999). Since beginning of June, Latvian government established a ban for imported beef, which is to remain till the end of this year (Russian and Baltic Economies 23/99. Bank of Finland. Institute for Economies in Transition). Both actions are considered to be against the Baltic Free Trade Agreement.
[83] Under harmonized system, goods or combination of goods shall be regarded as originating when all component articles are originating products. When a set is composed of originating and non-originating articles, the set as a whole shall be regarded as originating provided that the value of the non-originating articles does not exceed 15 % of the ex-works price of the set. Ex-work price = the price after deducting any internal taxes which are, or may be repaid when the product obtained is exported. The European Commission, DG1; Origin of Goods.
[84] See more detail discussion: Mayhew (1998). 67-71.
[85] Mayhew (1998). 68.
[86] Upon the implementation of the harmonisation, the origin of a particular good is either the country where the good has been wholly obtained, or when more than one country is concerned in the production of the good, the country where the last substantial transformation has been carried out.

[87] See: The Europe Agreements, Article 27 in case of Estonia, and Article 28 in case of Latvia and Lithuania.
[88] The Association Council may decide on a different schedule for the elimination of the exceptional measures.
[89] The European Commission. DG1. Information Office. 12.4.1999.
[90] See related discussion: Mayhew (1998). p.93-99.
[91] Baldwin (1994).
[92] Indeed, membership and trade concessions of CEFTA are expanding.
[93] The first Single Market Review (completed at the end of 1996) showed, among others, that third country suppliers of goods, services and investment to the EU had benefited from the single market program just as much as people and companies within the EU.
[94] WTO
[95] WTO. http://www.wto.org: WTO Trade Reviews, WTO Implementation and Single Market Completion Lead to Greater Liberalization in the European Union (1997).
[96] Higher tariffs are applied especially to cereals, meat, dairy and poultry, sugar and tobacco.
[97] General Agreement on Trade in Services.
[98] European Commission. http://europe.eu.int: Agenda 2000, the legislative proposals. March 18, 1998. Brussels.
[99] See more: WTO. http://www.wto.org: WTO Trade Reviews, WTO Implementation and Single Market Completion Lead to Greater Liberalization in the European Union (1997), p. 11-12.

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