The Internationalization of the Baltic Economies

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Working Paper 130

May 1998

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Prepared for the Kreisky Forum and BRIE Policy Conference: *Foreign Direct Investment and Trade in Eastern Europe: The Creation of a Unified European Economy*, Vienna, June 5-6, 1997.

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Generous support for production of the BRIE Working Papers Series was provided by the Alfred P. Sloan Foundation.

1. Introduction

The three Baltic countries are often considered to be a group of relatively similar countries, but there are in fact, from both a cultural and an economic point of view, significant differences between them. This is also the case in relation to the speed and extent of the integration into the World Economy - into the economy dominated by the Western industrialized countries. How can these differences be explained? Are they a result of political choices concerning clearly defined explicit development strategies? Or have they arisen because of "implicit development strategies" influenced by a multitude of different factors? Both of the considerations are correct: Political choices direct the transition, but these choices have been influenced by many different elements as have the outcome of the political decisions. In the following I will present a model to analyze the interaction between the most important elements in the transition process. Focus will be on the change in institutions and activities related to the integration into the world economy - international trade and foreign direct investment into the Baltic.

I will commence by presenting a model developed in Mygind (1994) to be used for structuring the analysis and explaining the different transition strategies. Following a general introduction, the model will be used to give an overview of the most important factors determining FDI and international trade in relation to the specific country in transition. The analysis emphasizes the importance of background conditions in explaining the choice and impact of the transition strategy. Thus, the empirical analysis will start with a short account of the most important differences in the three Baltic countries background conditions. It will then be illustrated the political process is determined by these background conditions and how the political choices lead to differences in transition strategies. The differences in the general transition strategies will be related to the specific institutions and conditions of importance for international trade and foreign direct investment. Finally the actual results of internationalization on trade and FDI will be analyzed.

2. A model for analysis of societal changes

As well as illustrating a society with four subsystems, Figure 1 also shows the most important dynamics between these subsystems in the process of transition. The *institutional system* contains the formal rules governing the political process (constitution etc.) and the

economic coordination (property law, contract law, law on bankruptcy, taxation, regulation of the financial sector etc.). The *production system* includes the resources of the society - nature, production equipment and human knowledge. It also includes the structure of production and the results of production. The *value system* constitutes the culture (values, norms and preferences). The value system lies behind the informal coordination. The *social system* includes the different social groups and their mutual relations. It includes the distribution of power, income and wealth: The social groups can change the institutional system through *politics*. The *Outside world* has direct links to all the four subsystems. International trade and FDI play an important role.

Figure 1. The Relation between the subsystems in the process of transition

OUTSIDE WORLD

		Political alliances			Political cooperation supervision
SOCIAL SYSTEM Many losers in the first stages Loose organization of social groups Unstable political parties			**POLITICS** ----------------->	**INSTITUTIONAL SYSTEM** stabilization - tightness liberalization - speed privatization - distribution	
VALUE SYSTEM historical traditions ethnic/religious values discourse structures			<---------------	**PRODUCTION SYSTEM** restructuring, production, unemployment, inflation, international trade, FDI	
		cultural influence mass media			flow of goods capital, know-how

OUTSIDE WORLD

The most important change in the transition process concerns the *institutional system*, both the changes of political and of economic institutions. This includes liberalization, stabilization and privatization. The choice of new institutions, the choice of transition strategy, often results social conflicts. The new institutions define the conditions for the future distribution of power, income and wealth in the *social system.* This is especially true in the case of privatization, but also choices concerning stabilization and liberalization imply significant changes in the distribution. The very complicated mass of decisions to be made represents a tremendous task for the new political institutions. Furthermore, the social system is developing

rapidly. Some social groups are winners others losers in this often chaotic transition. For many people it is extremely difficult to follow and understand the changes. It is difficult to formulate clear interests and make political choices. It is difficult to develop stable organizations of interests. Therefore, many political parties find themselves in rather unstable conditions, in the early stages of transition.

For all countries in transition it is true that the *production system* has experienced a steep fall in production. This is because of the necessary restructuring of the system, going from a time when products were simply ordered by the bureaucrats to a time where preferences of the customers and costs of production determine production. Unprofitable production can be closed down quickly, but it often takes a long time and requires significant capital inputs to build up new types of production adjusted to the new market conditions. This adjustment process can result in a reaction from those large social groups affected by unemployment or drastic cuts in their real incomes. Such a reaction can impede the reforms so the "critical mass" of reforms is not achieved. This means that the market mechanism will not function. The agents will instead continue to use their resources in various forms of rent seeking by exploiting their contacts in the bureaucratic network.

Development in the *value system* can intensify the problems if, for example, ethnic or religious conflicts create instability in the social system. Such conflicts can be reinforced when some of the institutional changes have strong negative impact on specific ethnic/religious groups. The outside world also plays an important role. When the command economy broke down the input output flow of goods was cut and the fall in production spread in a chain process. In the following transition process new political and economic links are created, and inputs of know-how and capital play a vital role in the restructuring process.

Figure 2 shows the most important elements influencing FDI and international trade in the four subsystems and the outside world.

To create a positive climate for foreign investment in the **social system** it is important that broad social groups support the development toward a market economy and that a high degree of openness toward trade and FDI is generally accepted. A foreign investor will have to calculate the risk of a reaction towards both the development of the market economy and the security of private ownership rights and more specifically the risk of a reaction directed at foreign capital. If the social and political situation were very unstable with risk of radical

political changes, most investors, domestic as well as foreign, would hesitate. An important element in the social system in many countries in transition, is the strong power position of criminal networks. Cooperating with such organizations might have negative effects on the image of the foreign investor in other countries and not cooperating will make it difficult for the investor to make the necessary transactions and contacts in business as well as in bureaucratic relations. The prevalence of strong Mafia networks will be a significant barrier for FDI.

Figure 2. Conditions influencing FDI and international trade

	conditions for FDI	**conditions for foreign trade**
SOCIAL SYSTEM	social and political stability power balance between groups favoring or disfavoring FDI corruption and personal contacts Mafia involvement in business	the same but less important higher risk level can be accepted
INSTITUTIONAL SYSTEM	stability of political institutions **stabilization** inflation, economic uncertainty specific: instability of currency **liberalization** functioning market mechanism law enforcement, budget constraint specific: liberalization of foreign trade and FDI: tariff level, administrative control currency convertibility restrictions on capital flows tax-regime, implementation rules for remittance of profits **privatization** private property rights specific: rules for foreigners to join the privatization process foreigners right to own land	the same but less important the same for liberalization of trade and convertibility, not relevant not relevant
PRODUCTION SYSTEM	**market:** size and stability access to monopoly positions **factors:** important raw materials restructuring of production quality of technology quality of infrastructure quality of human resources: skills related to wage levels	important important for international competitiveness
VALUE SYSTEM	labor discipline entrepreneurial spirit market business culture attitudes to foreigners	important for international competitiveness
OUTSIDE WORLD	geographical distance cultural barriers Integration into international org. stability of international relations	very important

Instability in the social system will in most cases spill over into the **institutional system**. In some countries, like Russia, the dispute over the distribution of power between Parliament and President impeded the institutional reforms for a long time. However, for foreign investors the focus will be on the development of new market oriented economic institutions, the development of stabilization, liberalization and privatization in general and the specific development of the economic institutions in relation to foreign trade and FDI. In general, a successful **stabilization** with low inflation combined with political stability will reduce uncertainty and permit reliable economic predictions and thus decrease the risk involved in long term investments. For foreign investors the stability of the currency is important because of the large amounts of goods and capital expected to cross the borders.

Low inflation together with comprehensive **liberalization** create the basic conditions necessary for the market mechanism to function, which itself can be considered a fundamental condition for most foreign investments. From the foreign investor's point of view, it is especially important that the legal infrastructure is functioning (WB-1996). This includes legislation defining and securing property rights, contract law, company law securing the rights of shareholders in relation to management etc. It is not only important to have consistent laws. The legislation must also be easily accessible for the public. Foreign investors should have easy access to information about their rights and obligations. There must be an effective system of courts etc. to enforce the law without arbitrary bureaucratic decisions. It takes a long time to design consistent and comprehensive legislation for business activities. The whole package cannot be implemented in one step and many loopholes will occur. This is also related to the stability in the social system and in the political process. Strong groups can interrupt the process and create special advantages for themselves. Such groups have an interest in delaying the legislation, extending the period of possible rent-seeking. Contradictory legislation also gives bureaucrats fine opportunities for receiving bribes to favor specific groups. Consistent and easily accessible legislation can help avoid these problems.

Liberalization of foreign trade is an important part of deregulation, making it possible to exploit the advantages of internal specialization, at the same time as it creates a competitive pressure on the domestic enterprises. There will be social groups wishing to avoid or delay this part of liberalization. Different forms of, more or less, arbitrary administrative controls, known from the command economy, give certain advantages to the persons administrating the different

types of permissions. On the other hand, a speedy change to complete free trade might impose too drastic a shock on domestic enterprises, which would otherwise have been able to restructure with a more gradual adjustment of trade restrictions, e.g. in the form of general tariffs scheduled to be phased down over a certain period. Seen from the point of view of the foreign investor wanting to exploit the host market, some tariffs might be beneficial. In some cases the existence of tariffs can be the reason for choosing FDI instead of simply exporting to the specific country. For investors mainly exploiting the factors in the host country, a liberal trade regime is preferable. A convertible currency for current account transactions is necessary to ease this flow of goods. If the rules are unclear, administrative interference might not only be a barrier for trade flows but for FDI as well.

Liberalization concerning the possibility of starting new companies is of course also a precondition for most foreign investments. Closely connected to this is the specific legislation concerning capital transactions and remittance and taxation of profits. Lack of transparent administrative procedures of taxation will in most cases be a strong barrier to FDI, and will often promote different types of corruption. This will also often be the case in the **privatization** process, because many of the involved persons have special access to information as well as influence over the decisions. A foreign investor might be in a less favorable situation in this privatization game. On the other hand, privatization based on cashsales provide groups who, like foreign investors, possess large amounts of capital, with certain advantages. Therefore, the specific method and rules for privatization is crucial for the level of FDI in the transition process.

The development in the **production system** is probably most important for foreign investors. Their focus depends on whether they plan to exploit the market or the factors of production in the host country. It must be assumed that there are high transport costs or other barriers to ordinary exports if market seeking FDI shall be relevant. But even in without such barriers it might be profitable to take over an existing distribution network or build up companies mainly for assembly, distribution or sale and service. The establishment of this kind of activity requires the market to possess a certain size, actual or expected. Therefore, the turnaround following the initial fall in production and the achievement of stable growth, will often play a crucial role for the investor. A specific type of market oriented investment is privatization of companies with natural monopoly in local markets. Some foreign take-overs or JVs connected to public utilities or infrastructure fall in this category.

In practice, the market-motive is often combined with the motive of using local factors of production. Aside from taking over some of the main factors of production, a foreign investor also takes over a share of the local market when investing in a local production company. When combined with the ownership advantages of the foreign investor, the potential competitiveness of the local resources is decisive. Company specific conditions play an important role.

Why chose factors in one country instead of another? In short, it is a question of competitiveness, a favorable combination of price and productivity. For the countries in transition it is a matter of restructuring production and adjusting to the world market on both the input and the output side. The export performance of the economy in question can be taken as an indicator of this restructuring and competitiveness. For the Baltic countries, the question is how far the economy has succeeded in redirecting the foreign trade, earlier directed nearly 100% towards the former Soviet Union, to a broader specter of countries, with the neighboring Western Countries in the EU as core partners? What type of products are they importing and exporting? Is export based mainly on raw-materials and simple goods with low sophisticated labor content, or is it based on more advanced products? On the other hand, it might be profitable, if risky, for a foreign investor to invest in a country where restructuring is in an initial stage, because the foreign investor often has an advantage in the ability to implement such restructuring.

Access to raw materials at competitive prices might be an important factor for a foreign investor. Access to relatively cheap production equipment might also in some cases be important. However, the typical eastern production unit was based on outdated technology, with high-energy consumption and was often connected with numerous environmental problems. Often the equipment in these units would have a high degree of specificity and restructuring the factory would thus often entail scrapping most of the physical equipment. The buildings and the land might be of high value to the buyer, but in relation to land there could be problems with the restrictions for establishing foreign ownership. In relation to important inputs and markets for outputs, the location will also play a crucial role. Thus, the development of the transport and communication infrastructure is crucial.

The relatively cheap labor power in many of the Eastern European countries plays an important role for the foreign investor. What matters is the combination of price and quality - wage levels combined with levels of education and skills. Many of the more technical skills can be used directly, but skills connected to economic behavior in the new market economy will have

to be learned. Especially management skills create some of the most important bottlenecks for the economies in transition. However, in this particular area the foreign investor will have an advantage in being able to train the labor force and supply the necessary management skills.

The value of the labor-force, seen from the foreign investors' point of view, is closely connected to the **value system** at both the individual and at the group level. On the individual level it is a question of attitudes to the working situation - work-discipline. Are the employees motivated to work hard and take initiatives to improve the production process or do they stick to the old habits of low work intensity and passivity? How is the business culture? Do the employees identify with the companies' goals? Or is the company regarded as a necessary evil for receiving an income? The attitude towards the investor as a foreigner will be relevant in this context. A general hostile attitude could be an important barrier to successful foreign investment.

There is, in this context, a close link to the specific conditions in relation to the **outside world**. Both geographic and cultural proximity plays an important role. Just as large transportation costs can be a barrier to investment, difficulty in communicating with and motivating employees with different values, religion, habits etc. can create high costs for the foreign investor.

Relations to the international community are closely connected to the development of the institutional system. Integration into the EU entails a high degree of harmonization of important institutions. If this proves successful, it can be expected to supply foreign investors with good opportunities. If the country on the other hand, chooses to isolate itself from international organizations it will usually not be very open to foreign investors. Although a country is integrated in some economic organizations there might be other factors from the outside world, which can act as threats, seen from the foreign investors' point of view. Risk of one country entering into armed conflict with another countries often termed a high political risk. Therefore, security considerations also belong to factors affecting foreign investment.

Figure 2 does not show the interaction between FDI and the development of the different subsystems. However, there might be both important positive and negative dynamic links. In relation to the social system the most important interaction might be negative. The wealth foreign companies exhibit, and the relatively cheap prices they pay for their assets in the host country, can be used by national movements to discredit the idea of foreign investment, and thus, support a social and political reaction. In relation to the institutional system, the potential of

foreign investment gives the host country an incentive to improve the legislation to develop market institutions appropriate for foreign investors. In their contact with authorities, foreign investors might point to significant lacks in the legislative infrastructure. In relation to the production system, foreign investors can supply capital, technological know-how and, above all, management know-how. They can play an important role in restructuring production and appear as examples for domestic companies (Meyer, 1997). Because of the interaction between FDI and the development in the institutional framework and in the physical and the service-orientated infrastructure, the first successful FDI might lead the way for other FDIs. Thus, cluster effects in the development of FDI in specific countries, can be expected.

Many of the same elements influencing FDI have quite similar effects on foreign trade, see figure 2, but there are also examples where trade is an alternative to foreign direct investment. Large trade barriers, high transport costs etc might exclude the possibility of exports, and market seeking FDI will be the only relevant possibility for a foreign company planning to exploit the local market. In most cases, trade will be the first step in an entry strategy. FDI can be included afterwards when the foreign investor has sufficient knowledge about the local market. The first part of such market seeking FDI might be the establishment of sale offices and development the distribution system. Later stages might involve processing, assembly, servicing etc., transferring more of the value chain to the local market. Such a development will often mean that the borderline between market-seeking and factor-seeking investments is not very clear. Market-seeking investment will drive imports into the local market. Factor seeking investments will usually both mean increasing imports with inputs to the specific production unit and increasing exports of outputs. Therefore, international trade and FDI will often be closely related.

In general, many of the same elements will influence both trade and FDI. However, the involvement and thus the risk of using FDI is usually much higher than for trade. Therefore, political risk connected to instability in the social system is more important for FDI than for trade. Also the use of local labor power in FDI means that the value system will be quite important for FDI, and if cultural differences turn out to be an important barrier, the alternative to market seeking investments will be exports. The same argument can be applied to many elements in the institutional system. A successful stabilization policy affect both trade and FDI, but are most important for the latter, and this is also the case for the development of market

institutions. For the production system market-seeking investments and trade will both be attracted by the development of the local demand potential. Highly competitive factors of production will both facilitate factor seeking FDI and exports from both domestic and foreign owned companies.

If the conditions for FDI turn out to be more advantageous in one country, this country will often be used as a base for exports to neighboring countries - a foreign investment in Estonia might mean more trade between Estonia and Latvia. A parallel development of international trade and FDI can be expected when the structure of productions develops to cross national production networks where different parts of the value chain are placed in different countries.

3. Different background conditions of the Baltic countries

The Baltic countries have centuries of common history. Therefore, they are often regarded as a group. However, there are noteworthy differences between them when looking at background conditions in the four subsystems (Mygind, 1996), figure 3.

The production system in all three countries is strongly influenced by the Soviet type of industrialization with a small service and trade sector and with manufacturing based mainly on large and energy intensive enterprises, and with large parts of production related to the military. Both Estonia and Latvia had developed a light industry sector in the 1930s. Tallinn and Riga were important trade centers at the beginning of this century. Lithuania was dominated by agriculture and the greatest part of its industrialization took place under Soviet leadership.

The institutional system was integrated in the Soviet command economy; but during "Perestrojka" many of the economic experiments, introducing some market elements, were implemented in the Baltic countries, especially in Estonia which contained the highest number of semi private companies - "new cooperatives" and "individual enterprises" (Aage, 1991).

Figure 3. Background conditions 1989

	Estonia	**Latvia**	**Lithuania**
Production system population (mill)[1] land area(1000 km²)[1] NMP/cap USSR100 industrialization	 1,57 45,1 117 early	 2,67 64,6 119 early	 3,72 65,2 110 Soviet industrialization
Institutional system	highest number of new cooperatives and "individual enterprises"		strong state in medieval age
Social system[2] ethnic change during Soviet occupation titular national/total 1939 - 1945 - 1989	emigration to the West deportations of Estonians immigration of Russians to new industries Estonians: 92% - 94% - 61%	emigration to the West deportations of Latvians immigration of Russians to new industries Latvians: 77% - 83% - 52%	emigration, deportation low Russian immigration, agricultural workers to new industries Lithuanians: 76% - 80% - 79%
Value system language religion foreign influence	 Finnish/Ugrarian Protestant German influence	 Baltic Protestant German influence	 Baltic Catholic Polish influence
Outside world	close contact to Finland		

1) EIU country profile 1992/93, 2) Hanson, 1990

Both the dominance of the communist nomenclature and the national Russian dominance characterized the social system in the Baltic countries. Because of the Soviet occupation, many Balts emigrated to the West, and in the following years many Balts were deported to Siberia. Immigrants from other parts of Soviet moved in the opposite direction to work in the new and large, Soviet enterprises in the Baltic. In Lithuania, however, there was still a large reserve of labor in agriculture. As a result, the Russian immigration was much less significant here. In Estonia and Latvia the Russian speaking population soon formed the majority in the large cities and among the industrial workers. In Estonia the titular population made up only 43%, and in Latvia only 38%, of the industrial workers. In the agricultural sector, the titular population made up a clear majority in all three countries.

There is a close connection between the social system and the **value system**. For centuries the Baltic countries have had the same historical conditions; but at the same time there

are important differences in tradition, language and religion. The Estonian language is closely related to Finnish, while Latvian and Lithuanian belong to a specific Baltic language. Religion creates another line of separation. The two northern countries are Protestant while Lithuania is strongly Catholic. This difference is related to Lithuania's close historical links with Poland. Estonia and Latvia were strongly influenced by German culture. Note the connection to the early industrialization in the production system in the two northern countries. Compared to the rest of the USSR, more Estonians had a positive perception of the new private cooperatives (Aage, 1991). This is connected to the fact that Estonians had more experience with market reforms, but it can also be interpreted as an expression of a higher degree of individualism and strong orientation towards the West. In the Northern parts of Estonia the population could receive Finnish radio and television. In this way, there were also important differences between the three countries in relation to the **outside world**.

4. Differences in political development in the 1990s

The three Baltic countries experienced similar developments in their fight for independence up until 1991, except for the fact that the Lithuanians followed a more radical line of confrontation with Moscow. Even the Lithuanian Communist Party was actively fighting for independence. Also, the Catholic Church in Lithuania played an important role in the fight for independence. In Estonia especially, but also to some degree in Latvia, considerations for the large Russian minority softened the confrontations. It must be noted, however, that many of the Russian-speaking residents also supported independence.

After the failed coup in August 1991, and the beginning of Baltic independence, there was greater room for differences in the political and economic development strategies. In **Estonia** the economic policy became more neoliberal. Less than one year after independence, in June 1992, the Estonian "Kroon" was introduced and Estonia became independent from the "Ruble" and Russian economic policy. This was connected to a radical nationalist policy. The Russian speaking population, emigrated after 1940, did not receive Estonian citizenship. They had no voting rights at the election in September 1992. Not only the Russian minority as such, but also the social groups of workers were weakened. Estonian nationalist oriented parties won the election. They continued the neoliberal economic policy and the tough policy towards the Russian minority. Foreign influence modified the nationalist legislation, but the nationality

problem continued to be an important element in the political debate. The political attention was removed from the economic hardships of broad social groups, and the reaction towards the tough reform policy was not seen before the election in 1995. This reaction was so delayed that the positive results of the reforms had begun to surface, and the shift in government, did in fact not bring about important changes in economic policy. The "window of opportunity" opened by political revolution was in this way stretched over a longer period because of the development in the social system.

Figure 4. Overview of the political development

Baltic	Estonia	Latvia	Lithuania
Before independence 1990 election	civic front CP pragmatic pro Estonia 77% pro Soviet 23%	Oct. 1988 Civic Front CP split, strong Soviet wing pro Latvia 65% pro Soviet 30%	Sajudis, confrontation CP, tough independent line pro Lithuania + CP 95% pro Soviet 5%
After independence - before first election civic fronts split	no citizenship and voting rights to ARussians@ neoliberal economic policy economic break with Russia => June 92 Kroon	no citizenship and voting rights to "Russians", parliament in deadlock on citizenship rights and economic policy	introduction of citizenship law includes minorities, good relations with Russia, developed egalitarian values => voucher privatization
After first election more homogenous and well-defined interests Russian military out Aug. 93 Lithuania Aug. 94 Estonia, Latvia	election 1992: center right neoliberal, nationalist focus toward West election March 95: reaction center-government, only minor changes of economic and nationalist policy	election 1993: center-right cont. reforms, nationalist, often political deadlock, bank crisis summer 1995, election Oct. 95: reaction left wing, nationalists win, continued deadlock	election 1992:early reaction center left government continued reforms, egalitarian privatization internal government conflict bank crisis autumn 95 election 1996: center-right

The political development in **Latvia** is in many ways similar to what happened in Estonia, but Latvia faced more barriers. The Russians had a stronger role, both in the administration and at the management level in the enterprises. Latvia did not have as strong and direct ties with the West as Estonia had with Finland. The result was a more fragmented and conflict-ridden party system in Latvia. Legislation concerning citizenship rights was, as in Estonia, the most important political question, giving economical legislation a less important role in the political debate. However, while the economic policy was enforced by technocrats in Estonia (Purju 1996), the legislative process in Latvia was much more vulnerable because of the political deadlock which often characterized the Latvian parliament. Most of the Russian minority was also excluded from political influence. They will not only have to become Latvian

citizenship in the immediate future. However, some parts of the Russian-speaking population already had Latvian citizenship prior to the Soviet occupation. They and their descendants reclaimed these rights. This meant that the Russia-friendly parties had a certain role to play in Latvia. After the 1993 election, a center-right coalition was formed. However, internal conflicts led to many changes in the government before the next election in the end of 1995. As was the case in Estonia, there was a mild reaction, but both the left-wing parties and the nationalist-populist parties had a good election; consequently the political situation continued to be rather unstable.

In **Lithuania,** the national question did not play an important role. Most minority residents were granted Lithuanian citizenship from the beginning. Focus was primarily on economic policy. Furthermore, the Lithuanian workers had a relatively strong political position. There was not a "vacuum" on the left as was the case in Estonia and Latvia. Therefore, there was an early reaction to the economic recession in Lithuania. At the election in the winter 1992-93, the labor party with roots going back to the former Lithuanian communist party won a majority in parliament, and its leader was elected as president. This change of government was not followed by any substantial changes in economic policy. The civic front party, Sajudis, had already introduced a voucher program in 1991, which aimed at a fast privatization process with a relatively equal distribution of wealth. The Labor Party further developed this approach in 1993. At the same time, the new government strengthened the stabilization policy; partly because of pressure from the outside world; in this case the IMF. The labor government was divided by internal conflicts, especially on issues related to the finance ministries. A serious banking crisis in 1995-96 further undermined popular support. At the election in November 1996, the Labor Party lost a lot of votes, and the Conservative Party with roots in Sajudis was now the strongest party.

5. Stabilization, liberalization and privatization

Section 3 showed how the distribution of power between different groups in the social system influenced political developments and thus the transition strategy in the institutional system. The transition in **Estonia** started already during Perestrojka with the establishment of many semi-private enterprises and joint ventures with foreign companies. Already in 1990, Estonia was ahead in terms of attracting foreign investments. It had nearly as many joint ventures

as Russia (World Bank, 1992). In May 1989, the Estonian leaders designed a reform program aimed at establishing an independent Estonian Economy with own currency, a central bank, and an ownership structure consisting of both state-owned enterprises, private joint-stock, and employee-owned companies. From January 1991, Estonia had its own state budget, and a new tax system was gradually introduced. The new Bank of Estonia tightened the monetary policy, increasing interest rates quite drastically. However, it was not possible for Estonian to control the money supply as long as the country was still part of the Ruble area which suffered from hyperinflation in 1991-92. Therefore, the introduction of the "Kroon" in June 1992 was an important part of the **stabilization** policy. The "Kroon" was fixed to the DM in a currency board. The Bank of Estonia could only issue "Kroons" in direct relation to the foreign currency reserves. This system excluded an active monetary policy, and the fiscal policy was also restricted because increasing the money supply could not cover a deficit. The tough economic policy was supplemented by the fixed exchange rate as a nominal anchor for inflation. In the beginning, the "Kroon" was strongly undervalued in relation to the purchasing parity level, but at this stage of the transition, the Estonian enterprises had not yet adjusted to the new market relations and restructured production to exploit the export potential. When they started to do this, there was room for a real appreciation of the Kroon without substantial loss of competitiveness. The exchange rate remained. Inflation continued to be high but falling. It has now reached a relatively low level of 10-15%. This is probably a sustainable level since there are still a large potential for enterprise restructuring so that the competitiveness is not undermined.

The reason behind the high inflation in 1991-92 was the **liberalization** of prices, starting in the second part of 1990 and which was nearly completed in 1992. Exceptions were energy, public transport and rent. Liberalization in these areas was implemented gradually in 1994 and 1995 and further inflationary waves followed. The bankruptcy legislation was passed in 1993 and in spite of being one of the most tough laws in Eastern Europe (EBRD 1996), it has been effectively implemented, and many enterprises have been liquidated. Also banking legislation was strengthened, and in the end of 1992 three larger banks were put under administration and later liquidated or merged. Therefore, Estonia succeeded quite early in developing a rather healthy banking sector.

The liberalization of foreign trade has been quite fast and comprehensive. In 1993, nearly all goods could be freely imported and exported. Licenses were required only on imports.

Exports of alcoholic beverages, tobacco, and metals were terrified. On December 1991, Estonian made a free trade agreement with EFTA on industrial goods and an agreement with the in May 1992 EU, liberalizing trade with most industrial goods. In the summer of 1994, a free trade agreement was concluded with the EU for all the Baltic Countries and association agreements - so called "Europe agreements" were signed in the summer of 1995. As opposed to Latvia and Lithuania, free trade could be established without a period of adjustment, because Estonia had a very liberal trade regime from the beginning. Full membership of the EU will that Estonia will establish more trade-barriers to countries outside the EU (FIAS 1997). The development of a free trade zone between the three Baltic countries started to gain momentum after a summit in March 1994, and the Baltic Free Trade Agreement mainly covering industrial goods went into effect from January 1995 (January 1997 for agricultural goods). Already in 1991, rather liberal policies were adopted regarding foreign direct investment. In the first years, there were some special tax benefits for foreign investors, but they were removed in the new tax law from January 1994. Only a few sectors such as banking, mining, certain utilities, sales of medicine needs special licenses (Borros & Erkkilä, 1995).

Privatization in Estonia has been closely related to political developments in the country and the relation to the large Russian minority. Before independence when Estonia still depended on the support of the minority and certain goodwill from Moscow, the Estonian strategy was to transfer ownership from Moscow to local residents. Employee take-over was the dominant strategy in 1990-91. The reform program from 1989 included "people's enterprises" controlled by the employees. However, only 7 "people's enterprises" were established. 7 other large enterprises were privatized on an experimental basis at an early stage. Also here, large groups of employees took over most of the control. Insiders also had advantages in the small privatization process, but these advantages were eliminated by an amendment in May 1992. Out of 450 instances where small enterprises were privatized in the early period, 80% was taken over by employees (Kein and Tali, 1994). This percentage fell considerably in the following years. After the Estonian independence, the Russian-speaking workers lost most of their political influence. The nationalist government changed the privatization strategy away from insider take-over, which would have given the Russian workers a large part of the ownership

Figure 5. Stabilization, liberalization and privatization - 1990-96

Estonia	Latvia	Lithuania
Stabilization "currency board" => kroon fixed in relation to DM tight monetary policy tight fiscal policy proportional tax system	from autumn 1992 tough fiscal policy, budget crises tough monetary policy leads to appreciation of Lat later stable towards SDR	1993 tough fiscal policy tough monetary policy stabilization of currency from 1994 currency board fixed in relation to USD
Liberalization 90-92 price liberalization 1992 tough bankruptcy law 1992 liberalization of trade 1991-93 full open for FDI 1995 free trade with EU Sept. 1991 FDI law tax benefits phased out 1994 1993 foreigners can buy land but not trade it	1991-92 price liberalization 1992 bankruptcy, weak 1995 largest bank bankrupt 1993 15-30% tariffs 1995 4 years EU-adjustment Nov. 91/March 93: FDI law tax benefits phased out 1995 1994 foreigners can own land under certain conditions	1991-93 price liberalization 1992 bankruptcy, weak 1995 3 banks bankrupt 1993 tariffs 10-30%, 1995 6 years EU-adjustment Dec. 1990 FDI law 1992 more liberalization 1996 foreigners can own land still some tax benefit
Privatization before 1991 leasing, coops, employee-ownership 1992 no insider advantages small privatization 1991-93 1993 large THA-privatization => much sold to foreigners vouchers and reprivatization of housing and land	before 1991 leasing, coops, employee-ownership 1992 no insider advantages, decentralized adm., leasing, small privatization 1991-93, 1994 large privatization LPA vouchers 50% of payment housing: slow voucherpriv.	privatization program 1991: vouchers for all citizens small privatization: auctions large privatization: advantages to insiders, 50% at low price 1995 sale also to foreigners vouchers or reprivatization of housing and land

From 1993, the EPA, the Estonian Privatization Agency, privatized enterprises. The privatization method resembled the German Treuhandanstalt-model: sale after a tender with price, employment- and investment-guarantees, as the main criteria. Announcements were made in international newspapers to attract foreign investors. Foreigners went into the deals on the same terms as domestic capital except that Estonians could buy by installments. To open up further for foreign investment, it was decided in April 1993 to allow foreigners to buy land in relation to their production units. Before that time, foreigners could only get a long-term lease. Based on a sample of 400 privatized enterprises, we estimate that 37% of the assets were sold to foreigners (Jones and Mygind, 1997) The director of the EPA estimated that 20% of the

privatized capital were sold to foreigners, and if the foreign capital behind some Estonian buyers were included, the percentage would increase to about 40% (Baltic Independent 29-4-1994). The emphasis on foreign involvement in privatization and the choice of direct sale instead of voucher systems can not only be explained by nationalist objectives. Some of the nationalist parties wanted more emphasis on a voucher scheme that favored Estonian citizens. The strong Western orientation of the government might be explained by the fact that many of the ministers were technocrats that got a lot of their ideas from the West (Purju, 1996). The close ties with Finland are also part of the explanation. The strategy also shows the emphasis on core-investors. This has some advantages, especially in a situation without a well-developed capital market. However, the low sale prices and the concentration of capital led to a very unequal distribution of wealth and the majority of the population might feel that it was cheated in this process. Since 1995, some public offerings of minority shares have been carried out in some of the largest enterprises. The vouchers were distributed so that the Estonian speaking population got the highest share (Andersen, 1996). The Estonian voucher program was mainly directed toward privatization of housing and land. Also reprivatization was important here. The assets were given back to earlier owners or their descendants - mainly to Estonian speakers.

The economic transition in **Latvia** has many similarities with the development in Estonia, but it was slower and less consequent and successful in the turn toward Western markets. **Stabilization** was implemented a little later than in Estonia. There were greater problems in cutting down the deficit on the state budget and year after year there were fiscal crises and the government had to make drastic cuts in the public expenditures. The Lat. was gradually introduced in 1992-93. The exchange rate floated. A very tough monetary policy in 1992-93 resulted in an appreciation of Lat, not only in relation to the ruble but also in relation to the dollar. In this way, the Lat was used as a nominal anchor for inflation as in Estonia. In 1994, Latvia had the lowest inflation of the Baltic countries.

The **liberalization** of prices was nearly as fast as in Estonia. Legislation concerning bankruptcy was passed already in 1992, but the implementation was weak. A strengthening of the legislation for banks was implemented towards the end of 1994. Auditing showed that only 25% of the banks were profitable. The largest Latvian bank turned out to be in a serious crisis, and it was finally declared bankrupt. The banking crisis was a chock for the whole economy, postponing the turnaround in production. Foreign trade was gradually liberalized. In the

beginning of 1992, all controls on imports were removed. All export quotas and licenses were abolished in June 1992 and replaced with a system of export taxes. (IMF-Survey, 1992). A general 15% import tariff on finished goods was introduced in 1993. The Latvian agricultural sector was very influential politically and relatively high tariffs on food were established. Custom duties on food have been increased to a weighted average of 46% to support agriculture (WB-Lit 1996). As in Estonia, free trade agreements have been settled with the EU, EFTA, and the other Baltic countries. Free trade according to the EU association agreement will be introduced over a period of four years. Legislation on foreign ownership of land was in the first years quite restrictive, giving foreigners only the possibility to lease for 99 years. However, apart from this, the legislation on foreign investments has been quite liberal, and the parliament ratified the law allowing foreigners to buy land in December 1994 (EIU, 95:1). As in Estonia, uncertainty surrounds to the restitution process. Tax benefits for foreign investors were omitted in 1995. Only in a few sectors such as the mass media, national education, and natural resources do foreigners need special licenses (Borros & Erkkilä, 1995).

Conflicts and lack of political governance dominated the privatization process in Latvia for many years. It resembles the Estonian privatization in many ways except for its speed and the fact that vouchers played a bigger role in enterprise privatization. In Latvia, a larger part of the capital owners was Russian-speaking. The vouchers were distributed so that the titular Latvians received the largest share. As in Estonia, early privatization was based on new co-ops and leasing. Also here the privatization was rather fast in the first years, combined with advantages for insiders. In the next stage up to 1994, the administration of the privatization process was rather decentralized, and, although formally abolished, it gave still room for some insider advantages. Leasing with the option to buy was the dominant method of privatization. Most of the 200 large and medium-sized enterprises privatized in this period were taken over by insiders (Shteinbuka, 1996). In 1994, a new privatization law was passed. The control was centralized in the hands of the LPA, the Latvian Privatization Agency. It followed the Estonian model except from the fact that vouchers constituted a more important source of payment. The first international tender was announced in November 1994, and the number of privatized enterprises increased in 1995 and19 96. However, the speed did not match that of Estonia. Foreign investors were increasingly amongst the buyers, but privatization through foreign direct investment was still not as frequent as in Estonia. Privatization in the agriculture sector was

relatively fast whereas housing privatization has been rather slow. In both cases, the method used reprivatization combined with voucher privatization.

Compared with the two Northern countries, **stabilization** in **Lithuania** was relative weak in the first years of transition. Wage and monetary policy was later tightened, and the high inflation continued into 1993. Pressure from the IMF resulted in more wage controls at the end of 1992. This was bad timing for the conservative government. Real wages fell considerably just before the parliamentary election. Fiscal policy was characterized by relatively small deficits. Lithuania had problems in implementing an effective tax system. As a percentage of GDP, tax revenue in Lithuania was 8-10% lower than in Latvia in 1993-94 (Saavalainen, 1995), but the situation was improved in 1995. Lithuania stayed longer in the rubelzone. However, until introduction of the "Litas" in the summer of 1993, monetary policy including credits to large enterprises was tightened, and both inflation and the new currency were stabilized at acceptable levels. The exchange rate had already been stable for quite a while when Lithuania implemented a "currency board" in April 1994, fixing the Litas directly to the Dollar. This was done to give the stabilization policy more credibility.

Liberalization of prices started in February 1991, and only 15% of the prices were controlled in October 1992. In 1992, bankruptcy legislation was passed, but as in Latvia the implementation was very weak. In the beginning of 1995, the National Bank enforced a more tight banking legislation and during the autumn, three of the largest banks were forced into bankruptcy proceedings. This banking crisis nearly had as negative consequences as in Latvia. However, reconstruction was made more flexible with support from the IMF. Already in 1993, the first Baltic stock exchange opened in Vilnius. Lithuania was fast in this area, because most of the large privatization was implemented at an early stage of the transition. In July 1993, 10-30% tariffs on imports substituted the earlier licensing system. The average import tariff was 5,5% in mid 1995, and over 70% of the items had zero tariff rates (Cicinskas et al 1995). In July 1994, tariffs were increased on food products from an average of 25% to 44%. In October 1995, it was reduced again to 27.5% (IMF-Lit 1996). In the association agreement with the EU from June 1995, Lithuania obtained a six-year period in which tariffs should be reduced. As noted in the following, Lithuania had restrictions on foreign land-ownership up to 1997. In general, Lithuania has had more restrictions on foreign investments than the two northern neighbors (Borros & Erkkilä, 1995). This might be the reason why Lithuania also still has some tax benefits for

foreign investors. For investments over 2 mill USD, there is no profit tax for a period of 3 years from the start of profitable activity and during the following 3 years, profit tax is reduced by 50% (Lithuanian Investment Agency, 1997).

Lithuania is one of the first countries in Eastern Europe to begin the implementation of both enterprise and housing privatization. Already by the end of 1992, more than 50% of the assets were privatized (EIU, 1:93). Voucher privatization and employee ownership played an important role in this process. The emphasis on equal distribution and employee interests is strongly connected to the power structure in the social system. The workers had a much stronger position in Lithuania than in Estonia and Latvia. In Lithuania, nearly the whole population was united in the fight for independence, and in the following development the nationality problem (which had some relevance in relation to the Polish minority) played only a minor role. Instead there was already more focus from the beginning on distribution and economic policy. The communist party had a strong position in the parliament in 1990-92 and its successor, the labor party, won the election in the end of 1992. The main ideas for the privatization strategy were formulated in the reform program, which dated back to the days before the independence.

The cornerstone in the fast privatization process in Lithuania was the voucher system, which together with "cash quotas" were only given to residents in Lithuania. In this way, a barrier against a flood of rubles from the rest of the former USSR was established, but it was against capital inflows from the West. The sale of vouchers started in April 1991 and the sale of enterprises in September 1991. The vouchers could be used to buy both small companies, as payment for shares in larger companies, and as payment for housing. The voucher system combined with cash quotas limited the potential of large capital-holders including foreign capital to a large extent. Small privatization was, as in the other Baltic countries, nearly finished in 1994. From the beginning of 1991, only 10% of the shares in the large enterprises could be sold to the employees at relatively low prices. In April, this amount was increased to 30% and in February 1993, it was increased even more to 50% by the new labor government. Contrary to the situation in Estonia and Latvia, especially the later privatized enterprises had a high degree of employee ownership. Majority employee ownership was typical in the privatized manufacturing companies. In August 1992, a list of 114 state-owned enterprises/objects for unrestricted sale for foreign currency was published. By July 1995, the list had been reduced to 71 enterprises and of these only 46 were sold for 7 mill USD. This type of privatization was relatively slow, and

foreign sale could only be considered as a supplement of minor importance in Lithuania. In fact, since the Litas were convertible in the later stages, it would be more correct to call this part "cash privatization". It was primarily conservative opposition and not the labor party which resisted sale to foreigners, especially enterprises considered to be of strategic importance. The opposition feared Russian take-over. They also strongly resisted liberalization of foreigners' right to buy land. The conservative was for some years able to stop changes, because liberalization in this field needed a constitutional two-thirds majority. However, the legislation was a barrier for further integration into EU, and a parliamentary committee agreed in 1989 that foreigners from OECD member states should be allowed to buy land (Baltic Independent, December 15, 1995). The end of 1995 formally finished LIPSP. The remaining assets for privatization are to be sold mainly through tenders as in the other Baltic countries. The remaining part of the privatization process included a few leftovers from LIPSP; some state owned minority share holdings, and some large enterprises in the energy- and infrastructure sectors. It is expected that foreign capital will be strongly involved in this privatization. Housing privatization was also very fast in Lithuania. Already in 1992, 89% of housing was private (EIU, 1:1993), and an active market for real estate was developing. As in agriculture, reprivatization played an important role in housing privatization.

6. Paths of transition and the conditions for internationalization

The analysis of the transition process shows a strong relation between the background conditions in the four subsystems and the different paths of transition; both concerning stabilization, liberalization and privatization as well as the process of internationalization. Figure 5 summarizes the conditions concerning foreign direct investment and the internationalization of the Baltic countries. Figure 6 shows some of the most important results.

The social system has been rather stable in all three countries. Most stable has the political development been in Estonia, although there have been many government they have continued nearly the same neoliberal policy. There has only been a soft reaction from the population. The large Russian minority has not had voting rights for the parliamentary elections, and the political focus has for many years not been on the economic development but on the national question. Therefore the "window of opportunity" has been open for a rather long period in Estonia. Some of the positive results of a tough stabilization and a comprehensive

liberalization had shown up before the election in 1995, and the result was only very moderate changes in the economic policy. Latvia has been dominated by political deadlocks for long periods. Lithuania did not have an important Russian speaking minority, and they did not have the national question to distract the population from the economic hardship of early transition. Therefore, in Lithuania as in many other East European countries, there was an early reaction towards the economic problems, and there was a labor government of reformed communists for nearly 4 years until the conservatives came back to power at the end of 1996.

The political development strongly affected the development of the **institutional system**. Stabilization has been rather tough in all three countries with Estonia as the first country to have a stable currency and steeply falling inflation. For 1997, the Economist Intelligence Unit (EIU 2:1997) estimates the inflation to be 10-12% in all three countries. Estonia was first to implement comprehensive liberalization, and Estonia has in general been more radical and consequent in implementing legislation concerning elements such as a hard budget constraint, free foreign trade, and full opening to foreign investments. In short, all three Baltic countries have quite liberal legislation concerning foreign economic relations, but Estonia comes closest to the small open economy featured in many economic textbooks. In Estonia, the turnaway from Russia towards Western countries has been one of the main objectives of economic policy. This policy has been strongly influenced by the proximity to Finland and the national question. The early introduction of the Estonian Kroon was one of the first steps, and the liberalization of foreign economic relations continued this quite explicit development strategy with broad support in parliament. The Russian-speaking population and the workers did not have enough political influence to change this policy.

This is even clearer when analyzing the privatization process in Estonia, especially in comparison to Lithuania. When Estonia became independent, the privatization policy turned away from employee ownership which would have resulted in ownership transfer to especially Russian-speaking workers. Instead a model favoring core capital owners including foreign capital was implemented. In Lithuania, contrary to the development in Estonia, the insider advantages in the early privatization model was later extended and a large part of the Lithuanian enterprises were taken over by broad group of employees. Foreign capital was excluded from the Lithuanian privatization process in this way. This was also caused by the strong emphasis on vouchers and cash quotas leaving little room for capital owners in the privatization process.

Latvia followed the same privatization path as Estonia but more reluctantly because of political deadlocks. Added to this were probably also more problems related to personal networks and corruption in the relations between bureaucracy and enterprises.

Figure 6. Overview over the conditions for trade and FDI

	Estonia	**Latvia**	**Lithuania**
Social System	high stability Russians and workers low political influence broad support of market Quite low corruptions? Low Mafia activities?	often political deadlock Russians and workers low political influence weak support of market Quite high corruption? Some Mafia activity?	relative stability workers quite strong political position weak support of market Quite high corruption? Some Mafia activity?
Institutional St. stabilization liberalization privatization	OK from 1992-93 market functioning hard budget constraint full trade liberalization liberal regime for FDI quite fast 1993-95 foreigners very active in large privatization can own land from 93	OK from 1993 market functioning soft budget constraint some trade barriers quite liberal FDI rules Quite slow 1994-? foreigners can join large privatization can own land from 94	OK from 1993-94 market functioning soft budget constraint some trade barriers some FDI restrictions fast 1991-1995 insider advantages foreigners crowded out can own land from 96
Production System markets factors: raw materials technology infrastructure human resources labor cost	very small, fast growing int. purchasing power very easy access opening for FDI in utilities and infrastructure peat, wood, (food) some restructuring not important problem high educational level low, highest of Baltic	small, but growing int. purchasing power easy access opening for FDI in utilities and infrastructure wood, food low restructuring not important problem high educational level low, middle of Baltic	small, but fast growing int. purchasing power quite easy access opening for FDI in utilities and infrastructure wood, food low restructuring not important problem high educational level low in the Baltic
Value system	high individualism	high individualism	more collective
Outside World geography proximity cultural proximity int. relations	 Finland, Baltic Rim St. Petersburg area gateway to Russia Finland, Nordic ties EU agreements, 0 years	 Baltic Rim, Russia gateway to Russia Nordic ties EU agreements,4 years	 Baltic Rim, Belarus, Russia, Poland Gateway to CIS Nordic ties, Poland EU agreements,6 years

Figure 7. Economic results in the Baltic countries 1990-96

	Estonia							Latvia							Lithuania						
	1990	1991	1992	1993	1994	1995	1996	1990	1991	1992	1993	1994	1995	1996	1990	1991	1992	1993	1994	1995	1996
GDP growth %[1]	-8	-8	-14	-9	-3	3	3	-3	-8	-35	-16	1	-2	2	-5	-13	-38	-24	1	3	2
unemployment[2] %	0	0		4	4	4	5	0	0	1	5	6	6	7	0	0		4	4	6	7
inflation (CPI) %[3]	23	211	1076	90	48	29	23	11	224	951	109	37	26	18	8	225	1021	409	72	39	24
monthly wage Dec. $ [2]		16	65	77	178	272	290		12	52	118	188	213	242		10	27	70	115	167	194
av. monthly wage[2]			46	81	134	207	248			30	78	140	186	217			35	44	92	129	188
Budget saldo % of GDP[1]		5.2	-0.3	-0.7	1.3	-0.8	-2			-0.8	0.6	-0.4	-3.3	-2.0	-5.0	2.7	0.8	-3.1	-4.2	-3.3	-3.4

1996 estimate, 1) EBRD, 2) National statistics, 3) EIU.

The **production system** in all three countries experienced a drastic fall in production, but the fall was somewhat smaller and the turnaround faster in Estonia. GDP per capita and wages measured in USD were at the end of 1996, highest in Estonia, and the combination of growth in GDP and real appreciation of the currency has resulted in steep growth in international purchasing power. Although the market is relatively small, it is rather stable and fast growing. After some delay because of banking crises in Latvia and Lithuania, these markets are also developing in a promising direction.

The Baltic countries can also be attractive for factor seeking investors. Raw materials have not been an important motivation. Except for some peat in Estonia, the ground is not rich on minerals or metals in any of the three countries. However, primary production of agriculture and forestry must be noted as an important resource in all three countries. Although the Baltic countries had relatively advanced industries (e.g. electronics and the military industry) in the Soviet period, these enterprises have only in rare case technology and equipment, which are attractive for foreign investors. In most cases, the industrial equipment will have to be scrapped or strongly upgraded by the investor. Therefore, the human resources are the main factor for factor seeking international capital. All three countries have a high educational level, especially in terms of technological skills. Because of the initial undervaluation of the currencies, labor was extremely cheap in the first years of transition, and in spite of a considerable real appreciation and steeply increasing wages measured in USD, labor is still very cheap compared with Western Europe. However, not in comparison with many of the Asian NIC countries. The main question is whether the development in productivity can match the increasing wages? The wage level is the highest in Estonia, see figure 7. This is probably an indication of faster transition, faster restructuring, and higher productivity in Estonia.

Figure 8. Distribution of GDP on different sectors

% of GDP	Estonia		Latvia		Lithuania	
	1990	1995	1990	1995	1990	1995
agriculture and fishing	15.6	7.6	21.1	9.8	27.7	9.5
manufacturing	39.6	22.8	36.4	25.3	32.8	23.5
construction	7.1	5.3	9.8	7.7	10.5	7.3
transport	6.4	10.1	10.9	20.3	6.0	5.8
other	31.3	54.2	21.1	36.9	22.9	53.9
	100.0	100.0	100.0	100.0	100.0	100.0

Based on WB Statistical Handbook, 1996. For Latvia, transport includes communication

Figure 9. Distribution of production in manufacturing

% of total (current prices)	Estonia		Latvia		Lithuania	
	1990	1995	1990	1995	1992	1994
foodstuff	31.1	39.3	26.1	39.6	36.2	33.0
textiles, clothing, shoes	23.9	14.7	19.8	9.3	12.0	8.1
woodproducts, paper	10.4	10.7	11.4	17.9	3.3	3.0
chemicals, fuels, metals	10.7	17.5	17.0	16.5	25.4	35.4
machinery, instruments	18.3	12.4	20.8	9.7	5.8	5.1
other	5.6	5.2	4.5	7.0	17.3	15.5
total	100.0	100.0	100.0	100.0	100.0	100.0
In local currency, mill.	51	965	6100	18733		

WB, Statistical Handbook, States of the Former USSR. Lithuania, IMF 1995

Figures 8 and 9 give an overview of the restructuring of production. In all three countries, there has been a drastic change in the distribution of production on different sectors. This change is connected to the general restructuring of production away from products determined by the commands from Moscow to products determined by the demand of the customers and the costs of the inputs. Agriculture has fallen to less than half of the relative value. This both reflects a fall in production and a relative fall in agricultural price levels. Manufacturing has also fallen, both

in absolute and relative terms. Taking a closer look at the different branches in manufacturing, foodstuff has confirmed its position as the most important branch in Estonia and Latvia, and it is also the dominant branch in Lithuania. Especially textiles, and therefore, also the aggregated branch of textiles, clothing and shoes have lost in relative importance. Wood and wood products have increased in importance in Latvia. The broad group of chemicals, fuels, and metals has increased in importance in Estonia and Lithuania - in Lithuania mainly because of a revival of oil refining production (24.2% of manufacturing production in 1994). In Estonia and Latvia, the branch producing machinery and equipment has lost much of its relatively high importance. In Latvia, the branch radio and TV equipment, falling from 10% to 1.6% mainly caused the fall.

The geographical location of all three countries at the Rim of the Baltic Sea gives an advantage when trading with Northern Europe. In all three countries, this part of the infrastructure has been further developed in recent years. Estonian harbors often have problems with ice in the wintertime, giving an advantage to the two more Southern countries. The road network is of relatively high standard although the North-South link, Via Baltic, needs heavy investment before it can work as a strong link with Central Europe. The railway system also needs large investments to support the economic integration into Europe. This is also the case with air traffic and telecommunication. As described in the next section, large investments have already reached some of these sectors, partly because of foreign investors.

It is difficult to document differences in the **Value system,** which have strong influence on FDI and international trade except for the differences connected to the Russian minorities, which have had indirect effect through the social system. The stronger German/Nordic influence in Estonia and Latvia might have caused a more individual attitude compared to the more traditional and catholic tradition in Lithuania including a higher degree of collectivism. Thus Lithuanians might be more hesitant toward foreign investors.

The influence of the **outside world** is closely connected to the development of the infrastructure, determining the cost of transportation for goods and people. Here, Estonia has its geographic proximity with Finland as a special advantage. On the other hand, the two Southern countries are closer to Central Europe. All three countries have developed their role as a gateway between East and West. Estonia more specifically directed toward the St. Petersburg region. Lithuania to a higher degree covers the Belarus and Ukraine. The cultural and linguistic proximity between Estonia and Finland is probably one of the most important advantages for

Estonia. All three countries have relatively close ties with the Nordic countries as a whole and all three countries are heading for EU membership.

7. The internationalization of the Baltic economies

After outlining the specific conditions for internationalization, the actual development in international trade and FDI can now be described. The restructuring of trade can both be taken as an indicator of restructuring of production in general and as a measure of international competitiveness and thus attractiveness for factor seeking FDI. Therefore, the development in trade will be analyzed first.

Before the transition all three Baltic countries were strongly integrated in the Soviet command economy and almost all their "foreign" trade was with the rest of the Soviet Union. Even trade between the three republics was quite limited. Of the three Baltic countries, **Estonia** performed the speediest restructuring of trade, this was mainly because of the countries close ties with Finland as well as its swift liberalization process, The CIS countries share of both exports and import fell rapidly, see figure 10. Already in 1992 Finland turned out to be the most important trading partner and in 1996 it counted for 20% of exports and 33% of imports. In 1992-1996, Russia was in second place followed by Sweden, Latvia, Germany, and Lithuania, see figure 12. Also the regional trade with Latvia and Lithuania grew rapidly. The Kroon and the fast liberalization process were the main factors behind this remarkable switch.

The balance of trade was negative in 1990, but because of the speedy price liberalization, the terms of trade with Russia improved for the Estonian firms. The Russians were willing to buy because the market in Russia still favored the seller. After the price liberalization in Russia in January 1992 and the transition to world market prices, the terms of trade Estonia deteriorated again. This was partly neutralized by the switch to Western markets, but in the following years Estonia had a high, and increasing, deficit in commodity trade. The restructuring of industry and the increasing productivity was not effective enough to follow the real appreciation of the Kroon. The negative development in the trade balance worsened in 1994-96. However, Estonia had a large surplus in sectors such as tourism and sea transport, and foreign capital in the form of gifts, loans and direct investments grew, so the net result was an inflow of capital and increasing foreign currency reserves (EPB, 1997).

Figure 10. The economic internationalization of the Baltic countries 1990-96

	Estonia							Latvia							Lithuania						
	1990	1991	1992	1993	1994	1995	1996	1990	1991	1992	1993	1994	1995	1996	1990	1991	1992	1993	1994	1995	1996
Export per cap. USD[1]			299	538	879	1248	1360			316	385	391	515	551			228	543	545	727	848
export % GDP[1]			46	49	57	51	43			61	46	27	29	28			43[3]	73[3]	48[3]	45[3]	41[3]
tradebalance % GDP[1]	-2.5[5]	8.5[5]	-8.9	-8.7	-16	-19	-19			-16	-7.3	-10	-11	-17			0.5	-10	-7.2	-5.6	-4.7
curr. acc. % GDP[1]			3.6	1.3	-7.4	-5.1	-6.8			1.8	6.9	-2.4	-3.7	-4.0			1.1	-4.7	-4.1	-3.0	-2.6
% export to CIS[1]	94	82	34	30	30			95	97	45	47	43	37		94	85	65	57	47	41	
% import from CIS[1]		72	40	22	20			75	87	38	39	30	28		80	83	79	67	50	38	
exchange rate/USD[1]				13.2	13.0	11.5	12.0			0.74	0.68	0.56	0.53	0.55				4.34	3.98	4.00	4.00
foreign debt[1]										43	225	359	430	443			94	281	448	757	1200
Gr. fixed inv. % GDP[1]			21	24	26	25		23	6	14	14	14	17	29	29	19	29	24	20	18	
Foreign inv. m$[1]			58	162	214	202	139[4]			43	51	155	165	171		25	27	61	60	55	80
FDI % of GDP			6	10	9	6	3			3	2	4	4	3		1	1	2	1	1	1
FDI per cap. $			38	107	142	136	94			16	20	61	65	69		7	7	16	16	15	22
FDI accum. m$			58	220	434	636	775			43	94	249	414	585		25	52	113	173	228	308

1) EBRD, 2) National statistics, 3) EIU 4) Estonian Bank 5) World Bank

Figure 11 shows that the reorientation of trade is closely connected to a change in the pattern between different types of goods. Foodstuffs as well as minerals and chemicals have increased their share of the exports to CIS to over 50%, and fuels, chemicals and base metals dominate imports from CIS. Timber and woodproducts, textiles, clothing and shoes, and machinery dominate the rapidly increasing exports to the EU. However, a rather large share of exports are either directly re-exported from warehouses (14%) or re-exported following some processing (20%). Only 29% of the exported machinery were of Estonian origin. Processing accounted for 60% of the exports and 10% was re-exported from customs warehouses, mainly to Russia, Ukraine, Lithuania and Latvia. The bulk of merchandise meant for processing in Estonia came from Finland and Sweden (EPB 2:1997). Estonia imports mainly machinery and transport equipment, but also food products from the EU. There are strong indications that the resources resulting from the increase in imports are used especially for investments. Gross fixed investment is relatively high in Estonia, see figure 10. Machinery constitutes a very high share of imports. If the foreign capital is used for profitable investments, increasing productivity and growth, the trade deficit is not a problem. However, there will be an increasing dependence on foreign capital and a bill to pay in the future, in the form of interest and profits to foreign capital.

Latvia has not been as effective in restructuring foreign trade. Exports make up a smaller part of GDP than is the case in both Estonia and Lithuania, and exports per capita is also the lowest in the Baltic. The trade with CIS is higher than for Estonia, but especially Germany, though also Sweden, Finland and the other Baltic States are of increasing importance in relation to both exports and imports. The woodproducts share of exports increased to 24% in 1996. Textiles and clothing are also relatively important (17%). Minerals, especially fuels, make up an important part of imports, but as in Estonia, machinery also has an increasing role.

Figure 11 Estonia's trade with CIS and EU for different commodities

	1992 exports		**1995 exports**		**1992 imports**		**1995 imports**	
	to CIS	**to EU**	**to CIS**	**to EU**	**CIS**	**EU**	**CIS**	**EU**
foodstuffs	22.6	38.6	35.3	10.2	5.3	26.3	8.0	15.0
minerals, chemicals	14.9	17.3	23.7	10.3	63.3	9.2	52.8	17.9
woodproduct, paper	4.6	3.5	1.9	19.1	1.8	1.4	5.7	5.2
textiles, shoes	19.0	9.7	4.5	20.1	6.0	9.6	7.5	12.4
base metals	2.0	7.1	2.6	9.5	5.7	2.3	10.2	6.9
machinery	14.1	2.6	8.4	17.8	5.0	27.1	3.3	26.8
transport equipment	14.0	5.1	16.5	3.2	10.4	18.5	10.4	6.6
other	8.7	15.9	7.3	9.9	2.5	5.7	2.0	9.1
total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
mill EEK	1935	761	5275	11368	2056	783	5476	19206

Based on ESA (Estonian statistical office, 1996)

Figure 12 Main trading partners 1996 (merchandise)

Estonia*				**Latvia****				**Lithuania****			
exports %		**imports %**		**exports %**		**imports %**		**exports %**		**imports %**	
Finland	18.3	Finland	36.2	Russia	22.8	Russia	20.2	Russia	23.8	Russia	29.1
Russia	16.7	Russia	12.9	Germany	13.8	Germany	13.8	Germany	13.0	Germany	15.7
Sweden	11.5	Germany	8.9	UK	11.1	Sweden	7.9	Belarus	10.1	Poland	4.4
Latvia	8.4	Sweden	8.4	Sweden	6.6	Finland	7.9	Latvia	9.3	Italy	3.9
Germany Lithuania	7.0 5.8	Holland Latvia	3.7 3.3	EU	44.7	EU	49.3	Ukraine	7.7	Denmark	3.6

**Estonia Pank Bulletin 2:1997, **EIU (2:1997)*

Figure 13 Distribution of foreign trade according to products 1996.

Estonia*				Latvia**				Lithuania**			
% exports		**% imports**		**% exports**		**% imports**		**% exports**		**% imports**	
textiles	17.3	machinery	21.9	woodprod.	24.4	minerals	22.7	foodstuffs	16.9	minerals	20.1
foodstuffs	16.0	foodstuffs	15.6	textiles	16.9	machinery	16.8	minerals	15.7	machinery	16.3
machinery	13.5	chemicals	13.7	foodstuffs	11.8	chemicals	11.0	textiles	15.2	transport e	9.9
woodprod.	12.7	textiles	11.6	metals	7.0	textiles	8.0	machinery	11.4	chemicals	9.5
chemicals	11.1	minerals	9.7	machinery	6.9	metals	6.4	chemicals	11.1	textiles	7.8
minerals	7.3	transport	7.8					transport	7.3	foodstuffs	5.8

**Eesti Pank Bulletin (2:97), **EIU (2:97).*

Lithuania's main exports are foodstuffs (17%) followed by textiles and minerals/ fuels. Fuels are also a significant part of the import side. In fact, oil refining is the most important industrial production in Lithuanian manufacturing and this is why minerals and fuels are not only important imports, but also important for exports. Imports of machinery are also relatively high in Lithuania.

The importance of foodstuffs and woodproducts in exports indicates that the primary ressource base plays a significant role. However, this must be seen in combination with the relatively cheap labor in the Baltic. Relatively cheap labor is the dominating factor in explaining why textiles and clothing play an important role. The substantially large part of processed re-exports is also connected with cheap labor. In 1996, 52% of Estonian clothing were made in Estonia, while 42% were processed in Estonia (EPB, 2:1997). Borsos and Erkkilä (1995) estimate re-exports to be approximately 25% of total exports in all three Baltic countries.

One of the main differences between the three countries, is that Estonia has been much speedier in turning its international trade towards the West. However, the two other countries are now catching up. The level of exports measured per capita, is now more than twice as high in Estonia compared to Latvia. The Lithuanian level lies between the northern neighbors. Estonia's high export level can only partially be explained by the small size of the country and the high proportion of re-exports. The cultural and geographical proximity with Finland is of greater importance, and perhaps the most important explanation is the speedier restructuring and more liberal trade regime in Estonia. The difference in liberalization of trade is most pronounced for food. It is worth noting that tariffs on food imports in Latvia and Lithuania imply that foodstuffs are much lower on the import side than it is the case for Estonia.

Some of the tendencies apparent in the international trade of the Baltic are also found in the development of FDI in the three countries. As shown in figure 9, **Estonia** has attracted by far the highest amount of FDI in the Baltic. This is the case both in absolute terms and especially measured per capita and as a percentage of GDP. Also in this field Estonia was an early starter. In 1990 the Estonians were already taking advantage of the possibilities in the new Soviet Joint Venture legislation. In the start of 1991 414 foreign owned enterprises were registered in Estonia. By the start of 1993 the number had increased to 3814 (Liuhto, 1995). By July 1996 5857 enterprises, or 9.4% of the total number of enterprises, were registered as "foreign property". The investment were strongly concentrated in the area around Tallinn with 82% of the foreign owned enterprises (ESA, 1996).

A large part of FDI in Estonia is directly connected to privatization. This is probably the reason why FDI fell in 1996 in comparison to 1995. There was not much left to be privatized. Only some of the large public utilities might, in the coming years give substantial amounts of FDI-privatization. According to the Bank of Estonia, by the end of 1996 54% of accumulated FDI was equity capital and reinvested income, while 46% was "other capital" (mainly loans from direct investors). For 1995 of the 202 mill USD direct investment, 50% was into share capital (17% in new and 83% in existing enterprises), 8% was reinvested income and 42% was loans from direct investors. In 1996 the investment pattern changed. Of the 139 mill USD FDI into Estonia, only 13% went into equity, 10% were reinvested income and 76% were loans from direct investors. Presumably, an important part of these loans is spent on investment in privatized enterprises. As a condition for a privatization take-over the investor typically guaranteed further investment. On average these guarantees have been on the same level as the actual price paid for the take-over of the enterprises (Mygind, 1996).

It is difficult to assess how much FDI influences investments and restructuring at the enterprise level. Estonia had the highest level of gross fixed investment in the Baltic - around 25% in 1995 compared to 17-18% in Latvia and Lithuania, see figure 10. However, since much of the FDI goes into equity there is no direct link between FDI and fixed investments. In the investment statistics for 1995 foreign investment is only included with 29 mill USD or 4% out of a total of 762 mill USD. In manufacturing, foreign investments make up 12% of total investment (ESA 1996), but still the effect of FDI is probably higher. In our investigation of around 600 enterprises in Estonia we find that for 1994 and 1995, compared to the average firm, foreign-

owned firms have higher capital intensity and easier access to bank loans. Total factor productivity is rather high for foreign owned enterprises. Foreign owned enterprises also have relatively high investments, but this has not yet paid off, since foreign owned enterprises have a lower return on assets than most other firms do. At the same time they have a higher average wage level and higher growth in employment (Mygind, 1997).

The distribution of FDI in different sectors seems to be quite stable over time, with around 50% in manufacturing and 25% in trade, see figure 14. The latest 1996 data from Estonian Bank also confirms this picture (EPB, 2:1997). However, the highest number of foreign owned enterprises is found in trade. Most of them are relatively small. At the end of 1993 there were 423 foreign enterprises in manufacturing and 1311 in trade (EME, 1994). This means that a substantial proportion of FDI is market seeking investment building up sales offices and distribution systems for goods imported from the West, and especially from Finland. Finland's investments are typically also rather small and concentrated in services and trade. By July 1994 Finnish companies owned 53% of the foreign enterprises and 20% of the accumulated FDI (based on Liuhto, 1995).

Foreigners also invest in non-controlling shares and bonds. By September 1996 portfolio investment in Estonia amounted to 140 mill USD of which 76 mill USD in equity and 64 mill USD in debt securities (EPB 2:97).

Measured in relation to GDP or per capita, **Latvia** has much less foreign investment than Estonia. The number of foreign owned enterprises was 3800 at the start of 1994 (Borros and Erkkil@, 1995). Based on materials from the Latvian Statistical Committee, out of the total number of 3100 enterprises with 20 or more employees, 168 or 5.4% had majority foreign ownership. For a sample of enterprises with less than 20 employees, 3.7% of the enterprises were foreign owned (Jones and Mygind 1997). In manufacturing, foreign owned companies made up 6% of the enterprises. Most foreign owned enterprises were found in manufacturing of foodstuff, woodproducts, clothing and instruments. In trade there was 7% foreign owned enterprises, (for wholesale alone 12%), and in the transportation sector foreign enterprises made up 13% of the total number. Foreign participation was highest in financial intermediation with 33%. This is connected to the fact that Riga has developed into quite an important financial center in the former Soviet Union. Looking at the distribution of the amount of FDI, figure 14 also shows that finance and telecommunication are the sectors attracting the highest FDI in Latvia. FDI in

telecommunication is dominated by one large privatization of 30% of the shares in Lattelekom carried out in 1994-95. It was sold to a Finnish-British consortium registered in Denmark (IMF-Lat-1995). As earlier mentioned the Latvian privatization process has been relatively slow, but it can be expected that FDI connected to privatization will have increasing importance in the next 2-3 years. This might also give manufacturing a stronger position in the distribution of FDI. Preliminary results for Latvia show the same tendency as in Estonia, namely that foreign owned companies have a relatively high capital intensity and a high level of investment. They also have quite a high level of productivity, but profitability is still rather low (Mygind, 1997).

Lithuania has the lowest level of foreign investments in the Baltic both in absolute and especially in relative terms, see figure 10. Foreign investment in Lithuania accumulated at the end of 1995 was 228 mill USD distributed in 5018 units. Of these 70% were JVs and 30% were wholly owned. At the end of 1996 the numbers were 308 mill USD in 5943 enterprises. At the end of 1995 the largest investors were UK, Germany and USA. Russia accounted for only 4% of FDI (WB-Lit 1996), see figure 14. At the end of 1996 the EU share of total FDI was 62% while the CIS share was only 6%, see figure 14. However, the percentage of the number of enterprises owned by CIS-capital was 31%. There might be a tendency so that CIS-owners are concentrated in trade with relatively small enterprises. In this sense there might be some similarity between Finnish FDI in Estonia and Russian in Lithuania. We do not have information on the exact distribution on different sectors, but like in the other Baltic countries, the largest investments are found in telecommunication and petrol (covering both exploration, refining and distribution, but also tobacco, beer and soft drinks, food, textiles and wood processing) have attracted high investment, figure 15.

In the coming years, some large enterprises, especially in public utilities are scheduled planned for privatization so there will be some potential for FDI. However, as in Estonia, most of the enterprises have already been privatized, and the low level of FDI is strongly connected to the Lithuanian policy, giving advantages to employees and Lithuanian citizens in general. When trading shares develops further we might see a tendency of sell-off of some of these share-holdings also to foreign investors. The development on the Lithuanian stock exchange indicates already such a development. According to information from the Central Depository of Lithuania, foreign portfolio investment made up 90 mill USD by the end of 1996. The total capitalization of shares at the Vilnius Stock Exchange was 900 mill USD for 518 companies of which however

only around 30% were actively traded. The daily turnover is only around 0.4 mill USD. As of December 1996, foreigners owned 36% of the total portfolio managed by brokers, while on April 1, 1997 they owned 45%. The value of shares owned by foreigners was 61 mill USD in December increasing to 95 mill USD in April 1997. This made up 22% of the actively traded shares of the Lithuanian stock exchange.

Figure 14. Foreign direct investment by investor countries (accumulated)

Estonia				**Latvia**				**Lithuania**			
end 1993[1] %		**end 1995[2] %**		**July 1994[3] %**		**Feb. 1995[4] %**		**end 1995[5] %**		**end of 1995[6] %**	
Finland	31	Finland	22	Denmark	31	Denmark	24	UK	21	EU	62
Sweden	22	Sweden	20	USA	18	USA	17	Germany	20	CIS	6
USA	10	Russia	10	Germany	9	Germany	11	USA	15	**enterprises %**	
Russia	6	USA	8	Sweden	4	UK	7	Russia	4	EU	35
Germany	4	Ireland	7	Russia	?			Sweden	4	CIS	31

1) Ministry of Economics, 1994, 2) Estonian Investment Agency, 3) Borsos and Erkkilä (1995), 4) IMF-Lat-1995, 5) IMF-Lit-1996, 6)Lithuanian Investment Agency,)A single high FDI project in telecommunication is registered in Denmark, but based on Finnish and British capital.

Figure 15. Foreign direct investment by sector

Estonia							**Latvia**		**Lithuania**	
end 1993[1] %		**end 1995[2] %**		**Jan. 1995[3]** manufacturing	**%** 52	**%** 25	**Feb. 1995[4] %**		**Jan. 1997[5] %** 28 largest FDI	
industry	45	industry	50	foodstuff	9	12	telecomm	33	petrol	34
trade	26	trade	24	chemicals	28	1	finance	29	tobacco food	23
finance	8	trans.+com.	12	metals	1	1	industry	25	telecomm.	15
services	7	finance	5	engineering	3	3	trade	8	textiles	14
transport	6	services	4	light industry	2	3			electronics	6

1) Estonian Ministry of Economics, 1994, 2) Estonian Investment Agency, 3) Borsos, 1996 4) IMF, Lat-1995, 5) based on survey from Lithuanian Investment Agency.

There is much similarity between the FDI pattern and the international trade pattern. FDI is most important for Estonia, and the most important trading partners also belong to the most important investors. The Nordic FDI is highest in Estonia. Moving to the South, the United States, the UK, and Germany play a larger role. The United States ranks second or third among the foreign investors in all three countries. The US trade ranks much lower, indicating that the American investors use investments as an alternative to exports. US companies often make

market-seeking investments such as retail food, tobacco, or telecommunications. For the EU companies and especially companies from the Baltic Rim countries such as Germany and the Nordic countries, trade between affiliated companies is relatively high, and we see a high volume of trade in the same sectors as we have seen in FDI sectors such as foodstuff, clothing, and woodprocessing. The investments are typically both market and factor seeking. Borsos (1995) finds that Finnish investments in Estonia typically complement trade, and they are mainly market-seeking. Swedish investment are more focused on manufacturing and more factor-seeking.

The combination of investment and trade point in the direction of the development of regional cross-national production networks. This is especially the case for Finnish and Swedish investors, but also many German and Danish investors are probably following such patterns. The high proportion of outward processing and the trade pattern are indicators of this development. However, it is too early in the development process, and we do not have sufficient data to describe the specific type of cross-national production networks, which are developing. However, there are some indications that the branches might be woodproducts in Estonia and Latvia, food in Latvia and Lithuania. Textiles might develop in all three countries, and machinery and equipment could also have a chance especially in Estonia.

There are also many examples of market seeking investments in monopolistic oriented branches such as transports, telecommunications, and energy. These investments are connected with privatization, and they have been implemented both in Estonia and Latvia while they are scheduled for privatization in Lithuania. For transportation, it is mainly companies from the region. In telecommunications, there are both Baltic Rim investors and more distant investors.

8. Conclusion

The idea behind this paper has been to use a comprehensive model for analysis of societal change to compare how different transition strategies develop and constitute different conditions for the process of economic internationalization in relation to FDI and trade. It is shown how differences in background conditions in the outside world and the four subsystems of society have strong impacts on the political development and, therefore, on the choice of transition strategies. In interaction with the background conditions these strategies result in a specific development of new market institutions in each country. These institutions set the framework for

the development of the production system both on a general level and more specifically in relation to the development of markets and factors of production of importance for international trade and FDI.

The transition strategies of the three Baltic countries have followed the same trend. However, there have been important differences, which can be traced back to differences in the background conditions: During the Soviet occupation many workers from the rest of USSR emigrated to Estonia and Latvia to become workers in the large Soviet type enterprises. In the less industrialized Lithuania the workers were mainly recruited from the countryside. Therefore, Lithuania had only a small minority of Russians compared to Estonia and Latvia with the Russian speaking population dominating the large cities and the manufacturing sector. When the Baltic got their independence these Russian speaking minorities lost their political influence, and the workers as a group had a weak position in the social system in Estonia and Latvia. Another background factor to emphasize is Estonia's cultural and geographic proximity to Finland.

These differences played an important role for the political process and thus for the more explicit choice of transition strategy: The national problem marked the politic development in Estonia and Latvia and extended the period for opening the window of opportunity". The Russian-speaking population including the majority of the workers had very little political influence and the social reaction on the economic problems was postponed in Estonia and Latvia. The Estonian government used the window of opportunity to implement both fast and comprehensive reforms in connection to liberalization. Latvian governments were to a higher extending paralyzed by political conflicts. Therefore, the reforms were slower and less comprehensive in Latvia. In Lithuania the workers were not dominated of a large Russian-speaking group without political influence. The Lithuanian workers were relatively strong, and there was an early reaction toward the reformers. However, the new labor government did not change essential elements of the reform policy, but the relatively strong position of workers were an important reason for the insider privatization in Lithuania. At the same time Lithuanian politicians were concerned about the danger of foreign, especially Russian, capital inflows.

The results of these political developments are reflected in the transition strategies chosen by each country:

Estonia implemented a fast and tough stabilization and liberalization policy. Privatization was at an early stage turned away from insider advantages, and the process gained speed after

1993 with emphasis on direct sale to core-investors, including good opportunities for foreign investors. Latvia also pursued a tough stabilization policy but a somewhat slower and less consequent liberalization. Privatization followed the same pattern as in Estonia, but did not gain momentum before 1995-1996. Lithuania was slowest in the implementation of a tough stabilization policy, and liberalization was not as comprehensive as in Estonia. Since workers had a stronger political role in Lithuania, insiders have dominated privatization, and foreigners were squeezed out of the process. Also in Lithuania, there have been more important FDI restrictions, especially concerning land ownership.

The general results of the development and restructuring of production and trade were a steep fall in production in all three countries, most severely in Latvia and Lithuania, followed by a hesitant upturn from 1994 and onwards. In Latvia and Lithuania, the upsurge was further postponed by a serious banking crisis in 1995. Inflation was stabilized, first in Estonia and Latvia, but later also in Lithuania. By 1997, inflation is expected to be only around 10% in all three countries.

Looking closer at the conditions for internationalization, the following tendencies should be emphasized:

Estonia has experienced a stable political development. The potential threat of open conflict with the large Russian-speaking minority does not seem to be a serious problem seen from the point of view of most foreign investors. There has been broad support in the population for the market reforms. The legislative framework for the market economy has been built rather fast, and the system has been implemented in a strict way. The strict bankruptcy procedures and the tough regulation of the banking system are good examples. This is combined with fully liberated international trade flows, and no barriers for FDI except for some uncertainty concerning the restitution process. Estonia's liberal trade regime meant that the EU association agreement was implemented without an adjustment period. Restructuring of the enterprises is being implemented, and fixed gross investments are relatively high. Estonia is a small market, but the international purchasing power is growing very fast. On the factor side, the only important raw material is peat. Products from forestry and agriculture are, however, also important. The educational level is high, and although Estonia has the highest wage level of the Baltic countries, it may be assumed that restructuring and increasing productivity mean that the labor costs per unit are still competitive. Estonia's technological base needs much upgrading, but

there are probably some potential in woodprocessing, textiles, as well as machinery and equipment.

Latvias political situation is not as stable as Estonia's, but the risk of a drastic change in the political climate would probably not constitute an important barrier for foreign investments. Unofficial networks are probably more influential than in Estonia, and this might be a more serious threat for foreigners. The legal system is quite developed, but the implementation is not as strict as in Estonia. The bankruptcy law has not yet been strictly implemented, and the strengthened regulation for banks resulted in a serious banking crisis in 1995. Regulation of international trade is quite liberal except for some high tariffs for imports of foodstuffs. There are no important legal barriers for FDI. Restructuring in Latvia seems to be somewhat more reluctant than in Estonia. Privatization is much slower and the level of gross investments lower. The technological base of the fixed capital is probably not attractive for many foreign investors. Products from forestry and agriculture are the most important primary resources. The price of labor is somewhat lower than in Estonia, probably reflecting a lower level of restructuring and productivity. Latvia's potential lies mainly in the clusters connected to wood and food products. However, there might also be a potential in Riga developing as an important financial center.

Lithuania has in spite of its changing governments between - the Labor Party and the Conservative Party - a rather stable political system. There are no threats of serious conflicts because of national minorities. Unofficial networks are probably of some importance as in Latvia. Also the legal development and lack of full implementation show some similarity with the development in Latvia. The level of gross fixed investment is the same as in Latvia, and this is probably also the case with enterprise restructuring. A strong cluster in food products might be a possibility in Lithuania, and oil-refining and related industries are substantial parts of Lithuania's industrial base. The wage level measured in USD is the lowest in the Baltic countries.

The development of infrastructure and geographical proximity to large markets is also an important determinant for the economic internationalization. The most significant common feature is the three-country location as part of the Baltic Rim together with Russia, Finland, Sweden, Denmark, Germany, and Poland. The differences worthwhile noticing is Estonia's closeness to Finland also in the cultural and linguistic sense, and especially Lithuania's closer relations to Poland, Belarus, and Ukraine.

These differences have resulted in the following international trade pattern:

Especially Estonia took a very fast and drastic change in its international trade pattern, orienting itself towards the West with Finland as the main trading partner already from 1992. By 1996, Estonia's exports per capita were 2.5 times the level of Latvia and 1.6 times the level of Lithuania. And for the two Southern countries, Russia was still by far the most important trading partner. Trade with Sweden and especially Finland is higher when we move to the North. Trade with the neighboring Slavic countries is more important for Lithuania. Germany has a larger role when we move south. The EU countries, especially Finland, Sweden, and Germany export mainly machinery and equipment to the Baltic countries. The Baltic countries export mainly timber, woodproducts, and textiles to the EU and mainly foodstuff and some equipment to CIS. Wood exports are more important in Estonia whereas food is in Lithuania. Primary resources from forestry and agriculture play an important role, but so does cheap labor. This is especially the case with large amounts of textile and clothing exports from all three countries. Outward processing is important in this sector with final markets in the West, and it is important for machinery and equipment for final export to CIS.

There is a strong connection between the pattern of trade and the pattern of most of the FDI into the Baltic. Especially Finnish FDI in Estonia has complemented the development of trade. They are mainly market seeking. Swedish investments are more concentrated on manufacturing and tend to be more factor seeking. In general, most FDI in the Baltic countries have multiplied and increased the trade and production linkages between the countries in the Baltic Rim region. The high proportion of outward processing indicates that especially Finnish and Swedish investors are establishing new cross-national production networks. As with trade, FDIs are falling as we go south, and the weight of the regional FDI from the Nordic country decreases as well. At the same time, the weight of the United States, the UK and Germany increase. The US is ranking second or third amongst the foreign investors in the three countries. The US share of trade is much lower, and US investments seem to be an alternative to exports. They are often markets seeking investments in sectors such as retail food, tobacco or telecommunications.

Estonia belongs to the countries in Eastern Europe with the highest FDI per capita. A substantial part of FDI in Estonia is directly connected to take-over payments in the privatization process. Another and increasing part is used for investments in the enterprises taken over by

foreign investors. 35-40% of the privatized assets in the enterprises has been taken over by foreigners and foreigners own 9 % of the enterprises. About half of the FDI has been invested in manufacturing.

Latvia attracts much less FDI than Estonia. The privatization agency are selling enterprises to foreign owners, but this part of the privatization process started later than in Estonia, and the process has been slower. Foreigners own around 5% of the enterprises. FDI is most frequent in finance, trade and manufacturing of foodstuffs, wood products, clothing, and instruments. The largest amounts have been invested in telecommunications and the financial sector.

Lithuania has the lowest FDI level of the Baltic countries. The low level of FDI in the privatization process can mainly explain this. The enterprises were instead sold to insiders or citizens in general. It can be expected that foreign investors will be active buyers of the shares that especially insiders will sell. Already now foreigners play a relatively large role in trading at the Lithuanian stock exchange. Nearly all-foreign investors are from the EU and the United States. Only 6% of the capital come from CIS. For this money, 31% of the enterprises have been taken over by foreigners. This implies that the CIS-owned companies are much smaller on the average that they're Western counterparts. It may be assumed that these investments are mainly in service and trade. The important sectors for Western FDI are telecommunications, petrol, food, textiles, and woodprocessing. In the last stage of privatization, market-seeking investments in monopolistic oriented branches in transports, telecommunications, and energy have increased in all three countries.

It is too early to ascertain the exact type of the cross-national production networks developing around the Baltic Sea. However, the fast development in international trade combined with increasing FDI shows that the Baltic countries constitute fertile ground for reorganizing production that could strongly affect the Baltic economies and have strong effects on the other countries situated at the Baltic Rim.

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