# Baltic free trade agreement: its scope in terms of elements of shallow

Economics, Trade

Lithuania, Latvia and Estonia became independent after the collapse of the Soviet Union. The path for independence was very similar for all three Baltic countries, and after becoming sovereign countries the Baltics continued mutual cooperation. In the mid 1990s Lithuanian, Latvian and Estonian Governments agreed to create a free trade area among the Baltic States.

This essay will try to analyse the scope of elements of deep and shallow integration after Lithuania, Latvia and Estonia signed Baltic Free Trade Agreement. Although in the regional integration among Baltic economies the EU played significant role, as the main purpose of the BFTA was to bring the Baltic States closer to the EU accession, but this assignment will try to disassociate from the influence of the EU as far as possible. Due to it the essay will focus on ten year period from 1991 to 2001, simply because after the Europe Agreement, signed 1998, the integration toward EU overlap the BFTA regional integration. Beside that, the essay will briefly review the theory of regional integration and will use some methods of the 'Sussex Framework'.

Method and theory

The early development of the PTA theory has been associated with the academics such as J. Viner and R. Lipsey. Viner in particular made distinction on trade creation and trade diversion. Trade creation involves a shift from higher cost domestic production to lower cost PTA country due to the shift the price paid by consumer is driven down. Trade diversion occurs when country shift its import from lower cost outside 'club' country to higher cost PTA member (El-Agraa, 1994, Pautola -Mol, 2003 )

According to Baldwin new regionalism now usually involves small countries with the link with a large countries or countries located geographically close to them. In addition regional integration involves deep integration but confers relatively minor advantages. While majority so called deep integration schemes, which started in early 1990s, have involved relatively shallow integration with long period of transition and primary focus on statutory border measures (Pautola -Mol, 2003).

Furthermore, Schiff and Winters (2003) introduce several principles which should be not violated by forming RTAs, so called the Rule of Thumb (see appendix 1). Generally, rules of thumb' allows an over all judgement on the likely balance of economic welfare effects to be drawn. Traditionally, RTAs could be assessed by using standard methods such as computable general equilibrium or partial equilibrium market simulation models and econometric analysis. But due to scarce analytical and negotiating resources in developing countries, which were Baltic States at the creation of BFTA, this study will rely on 'Sussex Framework' which was designed to cut through these difficulties. The framework deals with both shallow integration and deep integration and was used successfully used in practise (Evans et. al, 2007).

The Baltic Free Trade Agreement

Latvia, Lithuania and Estonia at the beginning of the 1990s were considered as developing economies. In this period all countries experienced very high inflation mainly due to banking crisis. Also the volume of foreign investment was very low in all three countries. Because of the soviet legacy the Baltic industries were state owned as the command economy was used and because of the shift towards market economy the privatization started. Baltic States had many economic and political problems basically they had to restore their economies (Hiden and Lane, 1994).

The EU and Baltic states established diplomatic and economic relations in early 1990s. Not surprisingly the EU membership was a main policy priority for Latvia, Lithuania and Estonia. In the dealings with the EU prior to 1995, Lithuania Latvia and Estonia were clearly treated as a single bloc, encouraging them to engage in project of mutual cooperation as a necessary step toward integration of the region into the EU. Therefore, the Baltic Free Trade Agreement was signed in September 1993 and came into force on April 1994 (Sumilo, 2006).

The BFTA created a free trade zone to extend trade and promote harmonious development of economic relations among Baltic countries. The BFTA abolished import and export tariffs on all industrial goods. However, this agreement excluded sensitive goods i. e. agricultural goods, fisheries, processed food goods and textile. The agreement provided also that new qualitative export or import restrictions would not be imposed (Pautola -Mol, 2003).

The further step towards closer market integration was made in 1996 when Baltic States agreed to cancel trade restrictions on agricultural goods, the agreement came into force in 1997. The agreement covered products only of the Baltic origin. All quantitative export and import restrictions and similar measures also were cancelled under the agreement, with the proviso that protective measures can be reintroduced if local production is under threat. A third and last phase of the BFTA was aimed at removing non-tariff barriers. This phase was completed in 1998 (Sumilo, 2006)

Finally, unlike the customs union the free trade area are not obliged to use common external tariff. The absence of harmonized boarder policy let to occur the 'cheat' trade. As some firms were wishing to avoid paying import tariffs to more protective countries i. e. Lithuania or Latvia and might attempted to import their products through less protective member i. e. Estonia. To minimize such activity the BFTA stipulated that freely trade goods must comply with the EU rules of origin. However, rules of origin measurement are very difficult to implement (Kazlauskiene & Meyers, 1997).

Assessment of Shallow integration

This term is used to describe integration based on national treatment. Shallow or negative integration entails removal and limitation on policies, as distinguished from deep effort to coordinate them. Usually RIA generally have only shallow policy integration aims, their objective is not economic union but an increase in competition through elimination of policy interventions and reduction of market segmentations (Schiff and Winters, 2003).

Firstly, by signing the trilateral BFTA agreement all Baltic States increased their market size to around 7. 5 million people. The BFTA created a bigger market for freer movement of goods, but the size of the market compare to the market of the EU was very small. Small economies like the Baltics are price takers in the world market because of the lack of bargaining power (Pautola-Mol, 2003). Beside that, the economic power of these young countries was also small, although the GDP indicator was growing constantly.

By the end of the 1990s Baltic were considered as mid-class economies. Furthermore, the RTAs with many union members are more likely to be trade creating (Jackson, 2007). Thus, the BFTA was signed just by three states and from table 1a and table 1. b it's obvious that the share of total import and exports among Baltic States was fairly small around 12 % although, study of Laser and Schrader (2004) and Hacker, S. and Einarsson, H (2002) suggest that the trade among the BFTA exceeded it potential.