Free Trade in the 1990s: Understanding Estonian Exceptionalism

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Every economist is familiar with the theory of international trade and learns to appreciate the merits of economic openness. As noted by the leading trade economist Paul Krugman, "if there were an Economist's Creed it would surely contain the affirmations 'I understand the Principle of Comparative Advantage' and 'I believe in Free Trade.'"[1] In reality, trade is almost never free. Countries levy tariffs, quotas, and countervailing duties; negotiate voluntary export restraints; launch anti-dumping proceedings; and impose various kinds of regulatory barriers to trade. Although there has been substantial liberalization of trade in recent decades throughout a number of countries (most notably in some emerging markets), genuine free trade has been achieved only in some exceptional cases, such as Hong Kong. In other words, there is generally a stark discrepancy between economic theory and political reality.

Estonia in the 1990s defies this generalization. The early adoption of a free trade regime, which was sustained throughout the 1990s, made Estonia somewhat akin to a European Hong Kong. This raises what I have elsewhere called the "Estonian puzzle."[2] At the end of the 1980s, Estonia was part of the Soviet Union and the economy was managed by central planning. Economic interaction with the West was minimal. As part of a package of radical market-oriented reforms, Estonia adopted unilateral free trade—abolishing tariffs on all imports, including agricultural goods—and reoriented its economic relations completely within a few years. Reforms in other areas of international economic relations were equally far-reaching and included liberalization of the foreign direct investment regime, current and capital account convertibility, and the introduction of a currency board, which has been sustained at the original parity for more than a decade.

The purpose of this article is to understand the emergence and sustainability of this remarkably open economic order and, more specifically, the free trade regime. After an overview of Estonian economic reforms with a focus on foreign

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economic policy in the 1990s, I turn to a political economic analysis of the factors leading to the adoption of free trade. In this context the free trade regime is also interpreted as part of a classical liberal policy package.[3] The next section discusses the likely effects of European Union (EU) accession on Estonian trade policy, and is followed with a final section of conclusions.

Estonia in the 1990s: Unilateral Liberalization on All Tracks of Foreign Economic Policy

The Estonian economy underwent profound and rapid changes in the 1990s. At the start of the decade Estonia was a constituent republic of the USSR and fully integrated into Soviet central planning. Production and investment decisions were determined largely by union-wide central planning, and economic relations with foreign countries were managed by foreign trade associations. Estonian exports outside the Soviet Union constituted about 2 to 3 percent of its GDP in the second half of the 1980s, with two-thirds of that going to other COMECON countries.[4]

Political independence was restored in 1991 amidst an escalating economic crisis. The breakup of the Soviet economic system left the small Baltic markets in a very vulnerable position. Their most important export market, the rest of the former Soviet Union, collapsed. Independence also imposed adverse terms of trade shock on a large scale as a result of massive and sudden price increases on energy imports. In the Baltic region as a whole, GDP declined by 40 percent and industrial production by 60 percent between 1990 and 1994, accompanied by hyperinflation in 1991–92.[5] Moreover, given the presence of Soviet troops and sizeable Russian-speaking minorities (especially in Latvia and Estonia), there was significant political uncertainty. The conditions at the outset of economic transition were therefore worse for the Baltic states than for the East Central European states that were part of the Soviet sphere of influence without actually being part of the Soviet Union.

Estonian policy reforms started earlier, proceeded more quickly, and were more radical than anywhere else in the former Soviet Union, even compared to the other Baltic states. Estonia had been in the vanguard of economic reforms prior to independence. The first joint Soviet venture was founded in Estonia in 1987, and the first Estonian private bank emerged in 1989. Internal price liberalization also started before independence, in October 1990. The currency reform leading to the introduction of the kroon, the Estonian currency, was launched in June 1992. In many ways this was the headline reform, and it added to the overall credibility of Estonia's economic policies by laying the foundation for successful stabilization and ending hyperinflation. Privatization was modeled on the German Treuhand approach, that is, using direct sales to strategic investors.

After a deep and prolonged recession Estonia resumed growth in 1995. Except for 1999—when the repercussions of the Russian crisis and a domestic banking crisis led to a short contraction—Estonia's growth performance has been among the most successful in Europe. Inflation has been brought under control and public finances are in good order. The major concern is high unemployment which, it should be noted, is lower than in many other transition countries such as the

TABLE 1. Estonian Economic Indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP growth, %	–14.2	–8.5	–2.0	4.3	3.9	10.6	4.7	–1.1	6.4
Inflation, %, end-year	1076	89.8	41.7	28.9	14.8	12.5	6.5	3.9	5.0
General government budget balance, % of GDP	–0.3	–0.6	1.3	–1.3	–1.9	2.2	–0.3	–4.7	–0.7
Average gross wage, USD, period average	N/A	N/A	134	208	248	256	283	337	288
Unemployment, end of period, registered	0.9	5.5	5.1	5.0	5.5	4.6	5.1	6.5	6.7*
Exports, USD million	430	766	1211	1660	1764	2275	2674	2437	3259
Imports, USD million	397	854	1557	2398	2876	3516	3928	3430	4237
Current account balance, % of GDP	N/A	1.3	–7.2	–4.4	–9.2	–12.1	–9.2	–5.8	–6.8
Nominal GDP, in bn USD	1.04	1.64	2.28	3.54	4.37	4.63	5.19	4.84	N/A

Sources: Estonian Statistical Office, Bank of Estonia, Bank of Finland, IMF.
*October.

other two Baltic states and Poland.[6] Tables 1 and 2 summarize Estonian economic policy and performance in the 1990s.

Foreign economic policy reforms were rapid in the three key areas: investment, payments, and trade. Estonia moved quickly to liberalize foreign direct investment (FDI) and introduced a legal framework for FDI only a few months after

TABLE 2. Milestones in Estonian Economic Policy Reform

Year	Milestone
1989	First private bank formed.
1990	Price liberalization started; abolition of state trading monopoly.
1991	Independence from the Soviet Union; small-scale privatization started; first wave of trade liberalization; law on foreign investment enacted.
1992	New Deutschmark-pegged currency board; new center-right reformist government led by Mart Laar; large-scale privatization started; bankruptcy law enacted.
1993	Establishment of Estonian Privatization Agency on the Treuhand model; abolition of almost all remaining tariffs; Baltic free trade agreement signed.
1994	Completion of small-scale privatization; full current account convertibility according to IMF Article VIII; full capital account convertibility; removal of remaining nontariff trade barriers; introduction of flat tax.
1995	Economy starts to grow after 36 percent contraction between 1990 and 1994; start of WTO accession negotiations; free trade agreement signed with EFTA and Ukraine; Association Agreement with the EU; application for EU membership; commercial code enacted; centrist government formed after the general election.
1996	Free trade agreements signed with Czech Republic, Slovakia, and Slovenia.
1997	10.6 percent GDP growth—the highest in Europe; European Commission recommends Estonia as one of six candidates on fast track to EU membership; free trade agreement with Turkey; last remaining (insignificant) tariffs abolished.
1998	Free trade agreements with Poland and Hungary; commencement of EU accession negotiations; Europe Agreement came into force; pension reform law adopted; EU-compatible competition law adopted.
1999	Three-party center-right government formed after general election; Estonia becomes 135th WTO member; law on introducing customs tariffs adopted.
2000	Customs tariffs on agriculture against third countries introduced. Tariffs due to go up to EU levels upon accession.
2001	Privatization agency closed after completion of railway privatization; steps taken to create unified financial supervisory organization to oversee banking, insurance and securities.
2002	New two-party coalition government with Reform and Center Party led by Siim Kallas; Estonia invited to accede to the EU and NATO.

Sources: Feldmann and Sally, 2002; EBRD *Transition Report 1999*; author's additions.

regaining independence in 1991.[7] National treatment applies and full repatriation of profits is guaranteed. The licensing procedures are simple and contain few restrictions. Estonia has been very successful in attracting foreign direct investment, and some of the inflows have been linked with privatization. By 1999 Estonia attracted USD 1,194 per capita in FDI, and Estonia is in third place after Hungary and the Czech Republic in terms of FDI inflows per capita in the 1990s.[8]

The payments regime was also liberalized swiftly. Estonia introduced full current and capital account convertibility in 1994. This was about two years after the introduction of the new currency, the kroon. The Estonian kroon was introduced in June 1992 in a period of hyperinflation and economic crisis. The bold decision was taken to adopt a currency board and to peg the kroon to the Deutschmark at the exchange rate of eight to one. This currency board arrangement has now been in place for more than a decade at the original parity, despite comparatively high inflation and substantial real appreciation (especially in the first few years). As noted by Pekka Sutela, Estonia also has been able to "combine the incompatibles," namely a fixed exchange rate, financial liberalization, and large current account deficits, without triggering speculative attacks undermining the currency board.[9] In the light of the numerous currency crises in emerging markets in the 1990s and the recent collapse of the high-profile currency board in Argentina, this is certainly noteworthy.

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The foreign trade regime underwent a dramatic shift, as the first post-independence government made a commitment to free trade in 1991. Import quotas inherited from Soviet central planning were removed in 1991–92, but without introducing tariffs other than on a handful of goods (and even these were phased out in 1997).[10] In 1991 more than 200 goods were covered by import quotas or licenses, and by the beginning of 1993 only five of them were still in force (all abolished by 1995). The average weighted tariff was 1.4 percent in 1993 and went down to zero in 1997.[11] The most remarkable feature of trade policy reform was that no tariffs were levied on agricultural goods. With one brief exception—tariffs against grain imports from Russia were in place for three months in 1993[12]—there was unilateral free trade in agriculture through the 1990s.[13] Moreover, there has been a fundamental reorientation of Estonia's foreign trade patterns. A decade ago trade with the West was negligible. Now more than two-thirds of foreign trade is conducted with the member states of the European Union (table 3); Finland and Sweden play a particularly important role, which is also reflected in their positions as the two biggest foreign investors (accounting for about 70 percent of total FDI inflow in the 1990s).

TABLE 3. Main Trading Partners (January–October 2000)

	Exports	% of total	Imports	% of total
1	Finland	31.2	Finland	28.7
2	Sweden	20.4	Sweden	9.8
3	Germany	9.3	Germany	9.8
4	Latvia	7.1	Russia	8.7
5	United Kingdom	4.6	Japan	6.3
6	Denmark	3.5	Italy	2.9
7	Lithuania	2.9	Latvia	2.7
8	Netherlands	2.5	Denmark	2.5
9	Norway	2.4	United Kingdom	2.3
10	Russia	2.0	United States	2.2
11	France	1.5	Netherlands	2.2
12	United States	1.3	France	2.1

Source: Statistical Office of Estonia, www.stat.ee.

As table 4 illustrates, Estonia's trade policy regime in the late 1990s is the most liberal in the transition world (and also in Europe in general) and is comparable to Hong Kong and Singapore. Unlike Estonia, the other two Baltic states—Latvia and Lithuania—maintained protection, most notably on agricultural goods, with high tariff dispersion and use of quotas. Even comparatively liberal Latvia had fourteen tiers of tariffs ranging from 0 to 75 percent in 1999, with an average production-weighted tariff of 35 percent on agricultural imports.[14] With a foreign trade to GDP ratio of about 186 percent, Estonia was one of the most open economies in the world (Ministry of Economics Web site, http://www.mineco.ee/valiskaubandus).

Unilateral liberalization has been complemented with bilateral, regional, and multilateral trade policy developments. Since the early days of transition, negotiating free trade agreements was a key priority. A large number of FTAs were concluded in the 1990s (see table 5 for a list of all the FTAs). What makes the Estonian case stand out is that the FTAs were concluded *after* unilateral liberalization; market access was not used as a bargaining chip in the FTA negotiations. Moreover, given that Estonia operated a unilateral free trade regime, there was no wedge between preferential and other tariff rates. This was another unique feature of Estonia's trade policy regime.[15]

Multilaterally, Estonia became a member of the World Trade Organization (WTO) in 1999. In preparation for EU accession and with the EU's Common External Tariff as a guideline, Estonia wished to bind tariffs in the WTO far above applied rates of 0 percent—an unprecedented situation for a WTO accession negotiation. Negotiations concluded with average Most Favored Nation (MFN) tariff bindings of just over 6 percent on industrial products and just over 17 percent on agricultural products. More attention also was accorded to non-border measures and regulatory aspects of trade policy.[16]

TABLE 4. Estonia's Trade Liberalization in Comparative Perspective

	Average weighted tariffs, in %, 1999	Trade to GDP ratio, 1999
Estonia	0	186.0
Bulgaria	15.1	87.7
Czech Republic	6.8	128.6
Hungary	13.3	137.6
Latvia	5.3	120.6
Lithuania	4.5	89.9
Poland	11.6	48.9
Romania	23.8	62.1
Slovakia	12	134.5
Slovenia	10.6	112.6
EU	5	74.5*
Hong Kong	0	219
Singapore	0.26 (1995)	255
New Zealand	3 (2000)	56
Malaysia	8.1 (1997)	221
Mauritius	14.54 (1995)	132
Chile	9 (2000)	55

Sources: IMF *World Economic Outlook*; IMF Occasional Paper 180; WTO *Trade Policy Reviews*.
*Simple average.

TABLE 5. Estonia's Free Trade Agreements

Country	Signed	In force/applied since
Bulgaria	11 December 2001	1 January 2002
Ukraine	24 May 1995	14 March 1996
Czech Republic	19 April 1996	12 February 1998
Slovakia	29 May 1996	13 March 1998
Turkey	3 June 1997	1 July 1998
Latvia and Lithuania	13 September 1993	1 April 1994
Poland	5 November 1998	1 January 1999
Slovenia	26 November 1996	1 March 2001
Hungary	4 November 1998	1 March 2001
European Communities	18 July 1994	1 January 1995
EFTA	7 December 1995	1 October 1997
Turkey	3 June 1997	1 July 1998
Faeroe Islands	27 November 1997	1 December 1998

Source: Estonian Ministry of Foreign Affairs homepage, www.vm.ee.

In recent years the regional (EU) track of trade policy has become predominant. Estonia concluded a free trade agreement with the European Communities in July 1994 and applied for EU membership in November 1995. The Association (or Europe) Agreements with the EU came into force in early 1998, and formal accession negotiations began the same year. The Europe Agreements provide the general framework for the associated transition countries' integration into the EU.[17] In 2002 Estonia was formally invited to join the EU along with nine other countries: Cyprus, Czech Republic, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. A referendum on EU accession was held successfully in September 2003.

The imperative of EU integration already has affected Estonian trade policy and led to a process of de-liberalization. The decade of unilateral free trade formally ended in January 2000, when Estonia started levying MFN tariffs on agricultural imports from third countries, that is, countries with which it does not have a free trade agreement. These tariffs have been moderate so far—the average weighted tariff on agricultural imports is now 3.3 percent—but the MFN tariff rates applied on third country imports of some specific goods are rather high. The applied rates are sometimes below (for example, tomatoes and cucumbers) or even at the WTO bound rates (for example, rye at 59 percent and pork at 10 to 59 percent). However, it should be noted that unilateral free trade still applies for all nonagricultural goods. This will change only when Estonia accedes to the European Union and adopts EU trade policy wholesale.

Understanding Estonian Trade Liberalization

The rest of the article focuses primarily on Estonian trade policy. The objective of this section is to provide an explanation for the adoption of unilateral free trade—an exceptional policy choice. The analysis of trade liberalization in Estonia makes use of a well-established taxonomy in comparative political economy and examines interests, institutions, and ideas.[18] In addition, I also consider the importance of the initial crisis in bringing about reform. The role of crises as catalysts for regime changes is well documented in the literature on policy reform.[19]

Crisis

As mentioned above, Estonian independence emerged in a period of severe economic crisis and dislocation. Hyperinflation, the adverse demand shock resulting from the collapse of the Soviet market, and the contraction of output were great economic challenges for the newly independent state. Unlike many other transition countries, Estonia also faced the political uncertainty surrounding independence—related to tenuous relations with Russia—and the task of creating the institutions of an independent state.

This crisis situation provides a backdrop to policymaking at the time of independence. Despite being very difficult for the country in question, crises also provide opportunities for radical reform. Indeed there are hardly any examples of radical economic policy reform that have not been preceded by crises.[20] It should be noted, however, that a crisis may be a necessary condition for reform, but that it certainly is not sufficient. Virtually all the former Soviet republics were facing

extremely severe crises, but only Estonia and the other Baltic states managed to implement rapid and successful reforms.

Moreover, given the loss of the Soviet market, the lack of trading relations with the West, and the size of the economy (which makes autarky virtually unthinkable), *some* liberalization of foreign trade was inevitable under these circumstances. Indeed transition in all former communist countries has involved movement toward greater openness, but it should be noted that Estonia is unique in going all the way to free trade. This confirms the role of a crisis as a catalyst but does not provide a sufficient explanation of radical trade liberalization.

Interests

Leszek Balcerowicz has labeled the initial phase of transition a "period of extraordinary politics."[21] Ordinary interest group activity—pushing for protection to support certain sectors—is suspended during this period of deep economic crisis. Most economic actors are simply preoccupied with their survival and lack the resources for lobbying activities. The absence of lobbying provides policymakers with a unique window of opportunity for far-reaching reform, which can override narrowly sectoral interests.

The period of Estonia's early transition can certainly be characterized as a period of extraordinary politics. As previously discussed, the initial crisis was more severe in Estonia than in many other transition countries, and this contributed to the weakness of organized interest groups.[22] However, four additional factors, which are more unique to the Estonian case, are worth examining. First, the role of the real depreciation stands out. The new currency was sharply undervalued in the first years after its introduction.[23] As a result, many imported goods were simply not affordable. In other words, the real depreciation effectively provided macroeconomic protection in the initial phase of transition and therefore reduced the potential demand for tariffs.

Secondly, compared to most other transition countries—notably the closest neighbor Latvia—heavy and large-scale industry was a relatively small part of economic activity prior to transition. The prevalence of such big industrial units complicates the restructuring process, and there may be a political need for a more gradual approach to avoid sudden and sharp dislocations. One might also expect big industrial units to be more effective in lobbying for protection, partly because of these high adjustment costs and the large number of employees affected by such a company's bankruptcy.

Thirdly, the main privatization strategy was the Treuhand method of auctions to strategic investors. This led to a weakening of the old insiders. Internal privatization might lead to greater demands for protection to smooth the transition by groups who are likely to resist change. Finally, the agricultural lobby was exceptionally weak—a key factor contributing to free trade in agriculture.[24] In this case, too, the choice of privatization strategy and especially the importance of restitution played a central role. By dissolving the old collective farms and replacing them with numerous small and dispersed farms, an important political force from the old system was removed from the scene. Again one might have expected the collective

farms to resist change and push for protection more forcefully.[25] However, it also should be noted that the food shortages in the last years of the Soviet Union are also likely to have reduced the potential lobbyists' interest in agricultural protection.[26]

In short, the weakness of organized interests provided an opportunity to bypass the usual lobbying activities, which tend to lock in protection.

Institutions

The role of institutions as a key variable explaining economic policy choices and performance has received more attention in both academic and policy circles over the last decade.[27] In the Estonian case, most political and state institutions had to be designed or created from scratch, even though some role models from the interwar period and other countries existed. It led to a shakeout of old elites, which was more far-reaching than most other transition countries.[28] This process catapulted a new generation of radical politicians and bureaucrats, mostly untainted by communist policymaking, into key positions. A prime example from the political sphere is Mart Laar, who served as prime minister in 1992–94 and again 1999–2001 and who was only thirty-two when first taking office.

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Similarly the Foreign Economic Policy Unit at the Ministry of Foreign Affairs (MFA) was manned with a group of young civil servants who had the task of drafting economic policy proposals. This generational factor and lack of experience may have contributed to a certain boldness and radicalism in trade policymaking. This has been particularly important given that the MFA has enjoyed significant institutional autonomy in trade policy making.[29] Although the economics and finance ministries also have some responsibility for trade policy (the latter especially for customs policy), the MFA has been the undisputed lead ministry, especially in the early 1990s. It has been responsible for the broad direction of policy and has coordinated with other ministries when their input has been required on specific issues.

Moreover, since the key institutions were newly created, there was no institutional experience of protection. This may have facilitated the adoption of free trade simply because the usual inertia was missing. Two examples are worth highlighting. First, policy rigidity may arise if tariffs serve an important fiscal purpose. In many developing countries, where tax collection is difficult, tariffs are a convenient way of financing public spending. Since tax reform is an arduous and complicated task—which may be unpopular in the electoral arena—politicians may find it hard to dismantle tariffs.

Secondly, countries that have a long experience of international trade negotiations and the "reciprotarian" logic of the General Agreement on Tariffs and Trade (GATT)—based on negotiations, managed liberalization, and mutual concessions—may find a jump to complete free trade unthinkable. Officials instead may recommend the use of protection as a bargaining chip in international trade negotiations. Estonia's lack of experience of independent trade policy meant that these common sources of fiscal and institutional inertia were missing.

Ideas

The third key political economy variable, namely the role of ideas, is harder to pin down and analyze. However, its importance must not be underestimated, especially in a period of dramatic change. Institutional autonomy and quiescent interest groups in a period of crisis may well provide a window of opportunity for radical policy change, but it is not clear a priori what the substance of these reforms should be. The salient ideas provide policymakers with a road map or compass for reform. I will concentrate on two sets of ideas—economic and political—which came very sharply to the fore at independence and, possibly even more so, under the center-right government between 1992 and 1995.

In terms of economic ideas, the command economy had been deeply compromised by the Soviet experience of sluggish economic growth, poor product quality, and innovation and pervasive shortages.[30] The attraction of a different set of policies based on free market or neo-liberal economics was very strong. These policies were embraced by most leading parties and have remained prominent throughout the 1990s. The weakness of radical leftist parties in Estonia testifies to that.[31] It also bears noting that unlike many transition countries (such as Poland or Lithuania) there is no reformist social-democratic party descending from the old communist structures in a dominant position in Estonia.[32] The elites' commitment to economic liberalism has been clear, and it has enjoyed comparatively strong popular support throughout the 1990s.[33]

The support for economic liberalism and free trade also is related to a set of important political ideas. The key priority for policymakers has been reintegration with the West; in the interwar period Estonia primarily traded with Western Europe (Germany and Britain).[34] Given Estonia's geopolitical situation, economic and political integration has been viewed as an insurance policy against potential Russian threats. A free trade policy and an open door policy to foreign investment were perceived to accelerate the process of economic integration with Western Europe. The recent invitations to join both the EU and NATO can be seen as the culmination of this decade-long process. It should be noted that the liberal policies were largely homegrown and not imposed from outside.[35]

The imperatives of high politics—the goal of joining Western Europe and also the thorny citizenship question—and their salience on the political agenda served to overshadow conventional economic issues to some extent for a time. This may have prolonged the period of extraordinary politics and made it longer than in other transition countries, thereby giving more scope for sustainable and radical policies.[36] In other words, the strength of neo-liberal economic ideas and the

political idea of integration with the West has been instrumental in the definition of policy.

Estonian Exceptionalism

To conclude, the initial crisis, interests, institutions, and ideas taken together created an atmosphere conducive to radical change. None of them would have been sufficient individually, since most transitional countries faced deep crises and periods of limited interest group activity. Many other countries also emerged as newly independent states. The one factor that may be somewhat more unique to Estonia is the strength of ideas conducive to liberalization—economic liberalism (underpinned by political ideas). However, without an environment conducive to these policies, these ideas almost certainly would have been stillborn.

As noted above, trade policy is only one—albeit probably the most striking and unique—element of Estonia's set of radical economic policies. I already have discussed the liberal foreign investment regime, as well as full current and capital account convertibility as additional components of Estonia's foreign economic policy regime. These policies, along with domestic laissez faire policies such as the flat income tax, have constituted a classical liberal policy setting in many ways similar to Victorian Britain.[37] Largely the governments have taken a hands-off approach to the management of the economy and eschewed activist industrial policy. The choice of the currency board arrangement has virtually made our counter-cyclical monetary policy an activist one. In other words, adjustment processes have been market-driven. As stated by former Prime Minister Mart Laar, the policies amounted to confronting firms with a stark choice imposed by market discipline: adjust or perish.[38] There may not be any necessary connection between trade policy and other aspects of economic policy in theory, but the political economy factors driving radical reform and favoring classical liberal, rather than interest-group driven or statist, policies have been similar in all of these policy arenas. The centrality of this aim has been a distinguishing feature of much of Estonian economic policy, especially in the early 1990s.

Sustainability of Free Trade

The adoption of a set of liberal policies does not necessarily mean that these policies are sustainable. In Poland, for example, trade policy was radically liberalized in early 1990, but a partial reversal occurred as early as August 1991. The average tariff on all commodities was raised from 5.5 percent to 18.4 percent, largely in response to protectionist pressures.[39] What is truly remarkable about Estonian trade policy—and also about the foreign investment regime, the capital and current account convertibility provisions, and the currency board arrangement—is that no real policy reversals occurred in the first decade following independence.[40] Three clusters of explanations can be used to explain this.

One explanation is that the political economy factors mentioned in the previous section have been surprisingly strong in the Estonian case. The weakness of protectionist interests, the relative strength of free trade ideas, and the institutional autonomy of the lead ministry certainly have played their part. Moreover, as a

result of foreign investment and restructuring new interests with a stake in an open trading, order has emerged. These new interests have been a balancing factor against protectionist pressures.[41]

Second, there are important linkages with other aspects of economic policy. The choice of parity for the currency board was very important. In the initial phase the depreciated real exchange rate gave Estonian firms some breathing space for adjustment and later mitigated the effects of the real appreciation. Moreover, the general policy setup or classical liberal package also bears noting here. The comparatively small budget deficits meant that there was less pressure to improve public finances by tariff revenues.[42]

Finally, the role of institutions as a lock-in mechanism also is worth examining.[43] In the early to mid-1990s, Estonia concluded free trade agreements with many of its most important trading partners. In the absence of comprehensive domestic legislation, the FTAs provided an initial legal framework to regulate international trade. This also helped to lock in the unilateral reforms, since international commitments make domestic regime reversals more costly and difficult. Therefore, the FTAs contributed to the credibility of the unilateral free trade regime. WTO membership provided an additional lock-in mechanism by compulsory tariff bindings and commitments in other trade-related policy areas. The Estonian case shows that the bilateral and multilateral trade policy tracks can be used to underpin unilateral liberalization, rather than being a stumbling block to it.[44]

The picture has been changing in recent years. Interest groups are becoming more effective at organizing lobbying activities, and the pressure especially for agricultural protection has been growing. Moreover, the ideological appeal of the neo-liberal model may not be quite as strong as in the early 1990s, even though right-wing and centrist forces still dominate the political spectrum. However, all of these domestic changes are dwarfed—or at least heavily constrained—by the impact of EU accession, to which I now turn.

Looking Ahead: EU Accession and Beyond

EU accession is driven by many political, economic, and security objectives, and is hence not primarily a trade policy matter. However, it is clear that it will have a profound impact on Estonian trade policy. As noted above, it already has led to the beginning of a de-liberalization process. Estonia will essentially cede trade policy competence to the EU level. In more practical terms it will have four important consequences.

First, Estonia will be required to adopt the EU's Common Commercial Policy. This means that complete free trade and eventually free movement of all factors with all current and new member states of the EU will apply. However, with respect to the rest of the world, this means that Estonia is moving away from the free trade position at the end of 1999 to the application of 10,794 EU tariff lines ranging from 0 to 1000.9 percent after accession.[45] Although the average EU tariff is low (about 4–5 percent *ad valorem*), it hides many peak tariffs and tariff escalation (on processed goods) in product areas such as agriculture, textiles and clothing, and cars and trucks. As some low-cost imports from third countries are

replaced by high-cost imports from elsewhere in the EU, some trade diversion inevitably will follow. This effect is exacerbated by the fact that Estonia is required to give up the FTA with Ukraine, which is likely to affect some sectors of the economy adversely.

Second, Estonia will have to introduce the whole system of nontariff measures—such as quotas, anti-dumping and rules of origin regulations, export subsidies, technical standards, and sanitary and phytosanitary measures—applied by the EU in relation to third countries. Imposing EU quotas on iron, coal, and steel, for example, may reduce cheap imports from the CIS and lead to significant price increases. Moreover, these nontariff measures violate the principles of simplicity and transparency, which have been the hallmark of Estonian policies so far.

Third, the process of trade policy decision making will change completely. Trade policy competence will be transferred to the Commission in Brussels. The small bureaucratic operation, led and coordinated by the Estonian MFA, will be subsumed into a large and complex EU trade policy machine. Estonia's influence on EU trade policy will operate through its seat in the Council of Ministers and, at the level of officials, in the Article 133 Committee. Estonian trade policy with non-EU countries therefore will have to be defined within this new policy and legal framework. This potentially may require a larger domestic trade administration, as some aspects of EU trade policy, such as dispute settlement cases of relevance to Estonia, may have to be monitored at the national level.

Fourth, the transfer of trade policy competence to the EU inevitably will break the nexus between trade policy and the other issue areas, such as tax policy. Whether classical liberal policies can be sustained in other areas of policy remains to be seen. It is possible that interests and ideas will respond to the modified institutional setup and change along many dimensions. This may lead to very different and more conventional policy choices by European standards.[46] In any case, the whole classical liberal policy package—encompassing both domestic and international economic policy—will no longer be feasible, since many policy areas will be decoupled and managed at different levels.

Conclusion

Estonian trade policy in the 1990s illustrates that free trade is an exceptional, but still feasible, policy option at the turn of the millennium. The political economy analysis of circumstances, interests, ideas, and institutions shows that many factors contributed to this policy outcome. None of them would have been individually sufficient to push Estonia to free trade, but the unique mix brought about this remarkable policy. Political economy factors, policy linkages, and external lock-in mechanisms have ensured the sustainability of these policies throughout the 1990s.

Even though trade policy has been an exceptional policy choice, it can be seen as part of Estonia's commitment to laissez-faire policies in the 1990s in areas such as tax policy, monetary policy, industrial policy, and the FDI regime. In other words, trade policy has been part of a policy package, and similar factors have driven reforms in the other policy areas.

EU integration, however, will require a complete overhaul of Estonian trade policy. Estonia will need to adopt the EU's tariff and nontariff protection in full, and the process of trade policy also will change completely, as policymaking competence shifts to Brussels. This can be seen as a reversal of the trade policies practiced so far. Finally, this de-liberalization process also will mean that Estonia is about to lose one element of its uniqueness in the last decade—its brand name as the "Hong Kong of Europe."

Notes

1. Paul R. Krugman, "Is Free Trade Passé?" *The Journal of Economic Perspectives* 1, no. 2 (Autumn 1987): 131.
2. Magnus Feldmann, "The Fast Track from the Soviet Union to the World Economy: External Liberalization in Estonia and Latvia," *Government and Opposition* 36, no. 4 (Autumn 2001): 537–558. Parts of this article draw on that article and on Magnus Feldmann and Razeen Sally, "From the Soviet Union to the European Union: Estonian Trade Policy, 1991–2000", *The World Economy* 25, no. 1 (January 2002): 79–106.
3. I use "classical liberal" in its European and traditional (nineteenth-century) meaning—what Americans generally refer to as "libertarian."
4. Kalev Kukk, "The Baltic States: Estonia, Latvia and Lithuania" in *Going Global: Transition in the World Economy*, Padma Desai, ed., (Cambridge, Mass.: MIT Press, 1997), 261-262.
5. Ibid., 262–264.
6. See the Web site of the International Labor Organization, <www.ilo.org>.
7. R. Shen, *Restructuring the Baltic Economies* (Westport, CT: Praeger, 1994).
8. Republic of Latvia Ministry of Economics, *Report on the Economic Development of Latvia* (Riga: Ministry of Economics, December 1999), 42.
9. Many factors have contributed to this outcome, including sound fiscal policy and relative lack of activity on Estonian financial markets. For a more detailed analysis see Pekka Sutela, "Managing Capital Flows in Estonia and Latvia," BOFIT Discussion Paper Series (Helsinki: Bank of Finland, 2001): 17.
10. Import duties on furs, cars, yachts, motorcycles, sea- and snow-scooters; an export duty on vintage cars. A. Purju, "Foreign Trade of Estonia: Factors Supporting Integration," Working Paper (Stockholm Institute of East European Economies), no. 113 (July 1996): 21.
11. Ibid., 20–22; World Trade Organisation, *Report of the Working Party on the Accession of Estonia to the World Trade Organisation,* WT/ACC/EST/28, available at <http://www.wto.org/wto/ddf/ep/public.html> (1999): 14–15.
12. S. Lainela and P. Sutela, *The Baltic Economies in Transition.* (Helsinki: Bank of Finland, 1994), 117.
13. WTO, 1999, 14–15.
14. International Monetary Fund (IMF) (1999), *Latvia: Selected Issues and Statistical Appendix,* Staff Country Report 99/99, available at <http://www.imf.org/external/pubs/ft/scr/1999/cr9999.pdf>.
15. For more detail, see Feldmann and Sally 2002.
16. Ibid.
17. For a more detailed analysis of the trade policy impact of the Europe Agreements focusing on the Polish case, see Magnus Feldmann. "The Association Agreement between the EU and Poland" in *Regionalism, Multilateralism and Economic Integration: The Recent Experience*, G. P. Sampson and S. Woolcock, eds., (UNU Press: 2003).
18. Peter Hall, "The Role of Interests, Institutions and Ideas in the Comparative Political Economy of the Advanced Industrial State" in *Comparative Politics: Rationality, Culture and Structure*, M. I. Lichbach and Alan S. Zuckerman, eds. (Cambridge: Cambridge University, 1997).

19. D. Rodrik, "Understanding Economic Policy Reform." *Journal of Economic Literature* 34 (March 1996); J. Williamson, ed., *The Political Economy of Policy Reform* (Washington, D.C.: Institute for International Economics, 1994).
20. Rodrik 1996.
21. L. Balcerowicz, *Socialism, Capitalism, Transformation* (Budapest: Central European University Press, 1995).
22. A. H. Hansson, "The Political Economy of Macroeconomic and Foreign Trade Policy in Estonia" in *Trade in the New Independent States*, C. Michalopoulos and D. G. Tarr, eds., (Washington, D.C.: The World Bank, 1994).
23. Lainela and Sutela 1994; Kukk 1997.
24. Feldmann 2001.
25. This hypothesis does not seem inconsistent with the experience of other ex-Soviet republics, where de-collectivization has been slow.
26. An economic adviser to the first Savisaar government in 1991 pointed this out to me.
27. For a good overview, see Dani Rodrik, "Institutions, Integration, and Geography: In Search of the Deep Determinants of Economic Growth," forthcoming in *In Search of Prosperity: Analytic Narratives on Economic Growth,* D. Rodrik, ed. (Princeton, NJ: Princeton University Press, 2003).
28. D. Arter, *Parties and Democracy in the Post-Soviet Republics: The Case of Estonia*, (Aldershot: Dartmouth, 1996).
29. For more detailed analysis of this, see Feldmann and Sally 2002.
30. J. Kornai, *The Socialist System: The Political Economy of Communism* (Oxford: OUP, 1992).
31. There are individual members of virtually all parties who have at some point been members of the Communist Party. No major Estonian party fits the label of a pointedly left-wing opposition to the policies pursued in the 1990s. The Moderates call themselves a Social-Democratic party, but have been loyal members of several center-right coalitions in the 1990s and support modifications rather than a complete overhaul of existing policies. Similar arguments can be made about the People's Union and the Center Party, even though there are important differences in emphasis and leadership style.
32. There is only one genuinely leftist deputy of among the 101 members of parliament—Tiit Toomsalu—whose party could be said to represent a more radical socialist opposition and also a degree of continuity with the old regime. It remains a very minor force in Estonian politics.
33. Despite numerous changes of government the basic orientation of economic policy has been remarkably stable throughout the 1990s.
34. Georg von Rauch, *The Baltic States: The Years of Independence 1917–1940* (London: C. Hurst and Co., 1974).
35. Technical assistance and advice, also by exiled Estonians like Ardo Hansson, was important, but on several issues (like the adoption of a currency) Estonia went against IMF advice (see Lainela and Sutela 1994). More recently, EU influence has become pervasive, as Estonia is trying hard to adopt the *acquis communautaire* and prepare for membership.
36. Niels Mygind, (1998), "The Internationalization of the Baltic Economies," *BRIE Working Paper 130*, available at <http://socrates.berkeley.edu/~briewww/pubs/wp/wp130.html>.
37. Feldmann and Sally 2002.
38 Interview with Mart Laar, March 2001.
39. IMF, *Poland: Selected Issues* (Washington D.C., 1998), <www.imf.org/external/pubs/ft/scr/1998/cr9851.pdf>; Wellisz, S. "Poland," in *Going Global: Transition in the World Economy*, edited by Padma Desai (Cambridge, Mass.: MIT Press, 1995).
40. More recently the trade regime has changed, but this has primarily been induced by external EU pressure.
41. Example: agricultural protection 1993.

42. Numerous factors—including initial undervaluation of the currency, fiscal prudence, and comparatively limited activity on financial markets — have contributed to this outcome. See Sutela 2001.

43. For more detailed analysis, see Feldmann and Sally 2002.

44. It should however be emphasized that the lock-in function was only one of several roles played by the FTAs and WTO membership. Improvements in access to key export markets and the reorientation of economic relations were other important objectives.

45. For a detailed analysis see Urmas Varblane, "The Trade Policy Implications of Joining the EU: Poland and Estonia Compared," in *Foreign Direct Investment in a Transition Economy: The Case of Poland*, M. Waresa, ed. (London: School of Slavonic and East European Studies/University College London, 2000).

46. New interests with a stake in a "Fortress Europe" may emerge and push for protection and potentially also for activist industrial policy. Perhaps, as sketched by former Foreign Minister Toomas Hendrik Ilves, Estonia will become more similar to Scandinavia in terms of the economic policies pursued: T. H. Ilves, "Eesti tee—pigem Põhjala kui USA mudel," *Eesti Päevaleht*, 16 October 2000, available at <www.epl.ee>.