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The Baltic Free Trade Agreement in Agriculture: Issues and Potential Impacts

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Abstract
The Baltic Free Trade Agreement (BFTA) was signed in 1993, took effect on April 1, 1994, and is intended to be the first step in the formation of a customs union. However, agricultural products (agriculture, food industry, and fisheries) were excluded from the initial text, which provided that a separate agreement covering the missing trade areas would be worked out. The process of reaching this agreement was a long and difficult one, and policy asymmetry was a major obstacle throughout the negotiations, since Estonia had no import tariffs and the other countries had tariffs ranging from 20 to 60 percent. Finally, in May 1996 leaders of the three countries personally agreed that they would accept free trade for all products of the three countries meeting a domestic rules of origin requirement. The governments of the three countries promptly worked out the specifics of an agreement, which was signed in June 1996. By October 4, 1996, the Parliaments of all three countries had ratified the agreement, and it became law on January 1, 1997.

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THE BALTIC FREE TRADE AGREEMENT IN AGRICULTURE: ISSUES AND POTENTIAL IMPACTS

The Baltic Free Trade Agreement (BFTA) was signed in 1993, took effect on April 1, 1994, and is intended to be the first step in the formation of a customs union. However, agricultural products (agriculture, food industry, and fisheries) were excluded from the initial text, which provided that a separate agreement covering the missing trade areas would be worked out. The process of reaching this agreement was a long and difficult one, and policy asymmetry was a major obstacle throughout the negotiations, since Estonia had no import tariffs and the other countries had tariffs ranging from 20 to 60 percent. Finally, in May 1996 leaders of the three countries personally agreed that they would accept free trade for all products of the three countries meeting a domestic rules of origin requirement. The governments of the three countries promptly worked out the specifics of an agreement, which was signed in June 1996. By October 4, 1996, the Parliaments of all three countries had ratified the agreement; and it became law on January 1, 1997.

This agreement is actually the first of its kind, since it provides for complete free trade in domestically produced agricultural and food products even prior to the formation of a customs union. The implementation process faces many challenges. In this paper we discuss various issues faced by implementing authorities and various factors that influence the market impacts of the agreement. We do not attempt to resolve issues or predict outcomes but rather to identify issues that are likely to arise and possible consequences of the agreement.

Impending Issues

It is usually expected that the larger trade region created by a free trade area (FTA) provides economic and political benefits, and these would also generally apply to the extension of the FTA to another sector previously excluded. These benefits include larger market access for firms, reduced transactions costs, improved investment climate, greater choice and lower prices for buyers, opportunity to build competitiveness through scale economies in preparation for expansion of the FTA (or joining another), mutual support in trade negotiations, and political solidarity. These and other benefits are accompanied by costs associated with the sacrifice of some degree of national autonomy in policy making and, of course, the costs of implementation. Countries enter FTAs because the benefits are perceived to exceed the costs. The fact that not all FTAs survive indicates that perceptions of these costs and benefits can change over time. Anticipating some of the challenges and roadblocks can help to avoid surprises in the implementation process.

One of the major differences among the countries that will have an impact on the BFTA implementation is the variations among trade and domestic support policies. There are two main aspects of this issue: how these differing policies will affect the implementation of the FTA and how future policy development will be affected by the presence of the FTA. The first issue is mainly related to market access within the FTA (nontariff barriers). The second is related to the possible adjustments in trade policies, which inevitably affect the domestic agricultural policies as well. The most important differences in policies are related to border measures and various domestic support policies (Table 1).

Trade Measures

Unlike a customs union, countries in an FTA are not obligated to harmonize border policies. However, there are pressures to reduce disharmonies to avoid arbitrage in trade. For example, companies wishing to avoid the import tariffs of Latvia and Lithuania may attempt to move products through tariff-free Estonia. To minimize such activity, the BFTA stipulates that freely traded goods must comply with the EU rules of origin. These vary by product but generally require that a substantial part of the value must originate in the member exporting country. Still, Estonian firms would appear to have the advantage in marketing some processed food products because of lower imported raw material costs. Moreover, rules of origin regulations are notoriously difficult to implement. Such pressures would probably hasten the steps to create a customs union, where border measures are harmonized. It is possible that the WTO accession process, in which all three countries are currently engaged, will lead to border

Table 1. Comparison of agricultural and trade policies in the Baltic States

Measures	Lithuania	Latvia	Estonia
Trade			
Imports	• Import tariffs (avg. 20-30%) • Import tariff quotas	• Import tariffs (avg. 30-50%) • Minimum import (border prices) • Import tariff quotas	• None
Exports	• Periodic export subsidies (1995-97) • Export restrictions for grain (1996)	• Grain export licensing • Export subsidies (1995) • Export promotion	• Export promotion
Domestic support			
Direct support	• Minimum purchase price • Purchase quotas • Farm price subsidies	• Minimum grain purchase price for grain reserves • Government grain stocks	• None
Indirect support	• Tax relief/reduction (social security, personal income, corporate profit, land tax [3 years], road tax) • Input subsidies (high quality seeds and breeds, electricity, compensation for diesel fuel excise tax increase) • Land reclamation • Infrastructure support • Rural business development • Advisory service • Partial loan guarantee scheme	• Tax relief/reduction (social tax, personal income, corporate profit tax, land tax) • Input subsidies (high quality seeds and breeds) • Land reclamation • Infrastructure support • Rural business development • Advisory service • Partial loan guarantee scheme	• Tax relief/reduction(social tax, income tax relief, corporate profit tax, land tax) • Input subsidies (compensation for diesel excise tax increase) • Land reclamation (drainage) • Infrastructure support • Rural business development • Advisory service • Partial loan guarantee scheme • Subsidized credit

measures that are more similar than current policies; but this is in no way assured. Even if there were strategy coordination, the outcomes could be different. However, there is no strategy coordination, so the similarity of outcomes is left to chance.

There is also a problem with differing standards and certification requirements, but this should be resolved as all three countries complete the process of adopting EU standards as part of their Association Agreements. Harmonizing customs procedures and regulations would also help in minimizing trade disputes.

The BFTA will reduce the ability to effectively implement national ad hoc trade interventions, which have occurred periodically. For example, grain export restrictions such as those that were adopted by Lithuania and Latvia in 1996 would not be as effective in limiting domestic price increases unless they were implemented simultaneously by all three countries. Otherwise, grain could seek a higher price by moving to the member country or countries without the restriction. Similarly, an export subsidy to dispose of surpluses in one country would be a less effective tool to raise prices in that country, because products from one of the other member countries could offset these effects. Actually, the wider market created by the BFTA could make such policy interventions less likely, because there will be a larger production base to absorb shortages and a larger market to absorb surpluses that may occur in any one country.

Domestic Support Measures

Unlike the other two countries, Lithuania has given significant emphasis to price policies. In 1995 Lithuania introduced a system of minimum purchase prices designed to provide a floor price on most farm products purchased by processors and direct price subsidy payments to farmers for a subset of these products. Not all plants were required to participate in this program, but the major processing plants were induced to cooperate due to preferential credit arrangements from the government and the growing competition for farm supplies. In 1997 the government began to reduce dependence on these programs, but where such programs lead to higher producer prices for a product in one country that are consistently above prices in another member country, processors in the high-priced country will be at a disadvantage. The prospect of losing competitiveness with firms across the border would ultimately weaken the government's efforts to continue such programs unless they were adopted by all three countries. Similarly, efforts by any government to enhance prices through intervention purchases will be less effective, because they could find themselves supporting prices in the other two countries as well.

All three countries have some forms of indirect support for farmers. These may have to be evaluated to see whether producers of certain products in one country are given an advantage over producers of the same product in other member countries. In the Canada-U.S. trade agreement that was later included in the North American Free Trade Agreement (NAFTA), there was a provision for investigation of production subsidies and offsetting them, where necessary, with a border assessment. This is a very long and messy legal process and can be triggered by a complaint from firms on either side.

Dispute settlement is usually a vital part of an FTA. Disputes seem to be a frequent occurrence in the life of FTAs, since it is impossible to anticipate all of the problems that will arise. While safeguard provisions are part of the BFTA, the mechanisms for using them are not yet defined. If the dispute settlement procedures are not already carefully defined, this will have to be one of the first tasks in implementing the agreement. This is complicated by the fact that basic legislation in the areas of anti-dumping and trade dispute procedures is still lacking.

The safeguard clause in the BFTA is a standard provision of international trade agreements and allows member countries to introduce temporary domestic market protection measures in extraordinary circumstances. The conditions and mechanisms to use the safeguard clause were not clearly defined when this agreement came into force, but these need to be carefully formulated and approved in order to reduce the number of disputes and avoid the misuse of these measures to violate the true spirit of the BFTA. The temptation may be strong at times for one of the governments, in response to domestic pressures, to use nontariff barriers under the guise of the safeguard clause to restrict intra-regional trade.

Potential Market Impacts

Two areas that are most likely to be affected by the BFTA are trade flows and market prices. The greater the price differentials among the countries the more changes one would expect in these variables. Shifts in raw material prices could also induce shifts in production patterns. Free flows of raw materials and processed foods within the FTA would ultimately lead to price differences that only reflect transport and handling cost differences by location (assuming that the countries actually permit free trade to occur). Retail price differences due to different VAT levels would persist, although these are currently the same in all three countries.

Studies of regional trade arrangements often begin with an analysis of trade creation and trade diversion. That is, to what extent does the FTA increase trade among the partners and to what extent does it displace trade with nonmember countries? Evidence on these figures will only be known after the BFTA for agriculture has been in place for more than one year. In 1994, intra-regional trade among the three partners accounted for about 11 percent of total exports and 5.4 percent of total imports (Table 2). Agricultural trade for the region had similar proportions. By 1996, intra-regional export shares and import shares had both increased slightly for all products, but the agriculture trade data are incomplete. These levels are low compared with a large FTA like NAFTA (Table 3) but not when compared with groupings of smaller countries like ANZCERTA (Australia-New Zealand), the Andean Group, CARICOM(Caribbean), and SADC(Southern Africa).

Table 2. Intra-regional trade as a percentage of total trade in BFTA

Region/country	BFTA	Estonia	Latvia	Lithuania
Agriculture and food 1994				
Exports	11.9	17.7	8.4	7.6
Imports	5.5	3.6	13.0	3.6
Agriculture and food 1995				
Exports	n.a.	13.0	8.5	8.8
Imports	n.a.	n.a.	9.4	3.8
All products 1994				
Exports	11.1	13.6	8.1	10.9
Imports	5.4	4.1	9.5	4.3
All products 1995				
Exports	10.2	12.2	8.6	9.3
Imports	6.2	3.6	10.7	4.9
All products 1996				
Exports	13.8	14.0	11.1	11.7
Imports	6.3	3.5	12.0	5.5

Source: Lithuanian Department of Statistics, n.a. indicates not available.

Table 3. Intra-regional trade as a percentage of total product trade in selected FTAs, 1994

Region	BFTA	NAFTA	ANZCERTA	Andean	CARICOM	SADC
Exports	11.9	48.4	8.8	8.5	15.0	8.0
Imports	5.5	37.4	7.9	9.3	6.6	8.3

Source: BFTA compiled by authors, other regions from S. Page, 1996.

The potential growth in intra-regional trade is limited by the fact that the three Baltic countries have fewer than eight million consumers and are very similar in production structure and comparative advantage. However, some trade creation and trade diversion should be expected as a result of specialization and improved competitiveness within the region. Relative competitiveness is already indicated by the fact that Estonia consistently had the highest intra-regional share of exports and Latvia consistently had the highest share of imports despite the fact that Latvia has had the highest import tariffs.

Differences in prices provide some indication of potential directions of trade and price movements. We look first at retail prices and later at farm prices. Retail prices are compared, excluding the VAT, to eliminate differences in VAT rates that were in place before January 1997. Wholesale prices would be more appropriate for this comparison, but these are not widely available. Only average prices are available, so these do not necessarily indicate the effects in border regions.

Retail Prices

Most retail prices have converged significantly over the past 20 months, but there are exceptions. Beef and pork prices have converged since mid-1995, but Estonian beef prices are somewhat lower than the other two countries and Lithuania has higher pork prices. In the case of poultry, Estonian prices were significantly higher in 1996, but since early 1997 they have been very similar. Although egg prices have converged, Latvian prices have remained consistently higher. Lithuanian milk prices were the lowest of the three until 1997, when Estonian prices were lagging slightly behind the others. Butter prices had extreme differences in early 1995, with low Estonian prices probably reflecting subsidized imports. These gaps have narrowed, but Latvian butter still remains the highest priced spread. Sugar prices have remained significantly lower in

Estonia, which has no domestic sugar production and imports refined sugar at world prices, while in Latvia and Lithuania sugar is one of the most highly protected products. Estonia has had the highest wheat bread prices and Latvia the highest rye bread prices, while Lithuania's bread prices have remained significantly lower. Potato prices are very erratic and respond mostly to local production variations, but Estonian prices have tended to be higher than in the other two countries. Potato prices in the three countries tend to be closer around harvest time.

In March 1997, Latvia had the highest price or was within 3 percent of the highest price for seven of the 10 products. There were five such products in Lithuania and two in Estonia. The data therefore may suggest that free trade in the early stages of the BFTA is likely to increase Latvia's intra-regional imports for many product groups.

Table 4. Retail price as a percentage of the highest country price, 1996 and 1997

	Estonia		Latvia		Lithuania	
Product	June-Dec. 1996	March 1997	June-Dec. 1996	March 1997	June-Dec. 1996	March 1997
			percentage			
Beef	92	90	100	100	99	99
Pork	89	94	89	88	100	100
Poultry	100	95	86	99	83	100
Eggs	96	90	100	100	83	87
Milk	99	86	98	97	94	100
Butter	95	85	100	100	92	90
Sugar	75	68	96	97	100	100
Wheat bread	100	100	89	94	66	76
Rye bread	96	94	100	100	67	70
Potatoes	99	100	89	80	75	71

Source: Compiled from Lithuanian Department of Statistics reports.

Relatively low beef prices in Estonia suggest some potential for exports of these products to Latvia and Lithuania under free trade. Low-priced Estonian sugar is irrelevant, since none of it satisfies the domestic origin requirement. Lower priced bread and other bakery products in Lithuania would face shelf-life problems in all but nearby border regions. Lithuania seems to have a competitive advantage in these products, and in potatoes, if transport and handling problems can be solved.

Farm Prices

Unfortunately, farm prices are not as regularly available as retail prices; but some comparisons are possible. In 1996, Latvian and Lithuanian pig and poultry farm prices were relatively similar, but Latvian cattle prices remained significantly higherer. Estonian cattle, pig, and broiler prices were significantly lower (Table 5). For milk, Lithuanian farm prices have continued to be lower than those in Latvia and Estonia. Grain prices are all near world market prices, with the highest prices recorded in different countries at different times. Sugar beet prices in Lithuania began to exceed those in Latvia after the introduction of higher sugar beet purchase prices by Lithuania in mid-1995.

Table 5. Comparison of farm prices in the Baltic States

Products	Average 1996	Percentage of Highest
	$/ton	percent
Cattle (liveweight)		
Estonia	581	76.4
Latvia	760	100.0
Lithuania	697	91.7
Pigs (liveweight)		
Estonia	968	74.1
Latvia	1,284	98.3
Lithuania	1,306	100.0
Broilers (liveweight)		
Estonia	1,101	77.4
Latvia	1,422	100.0
Lithuania	1,292	90.8
Milk		
Estonia	198	100.0
Latvia	193	97.3
Lithuania	139	70.4
Wheat		
Estonia	171	88.4
Latvia	173	89.0
Lithuania	194	100.0
Sugar beets		
Estonia		
Latvia	40	84.1
Lithuania	47	100.0

A significant factor in “competitiveness” at the farm level is that the Lithuanian support program pays direct subsidies to farmers for cattle, milk, rye, rapeseed, flax, and buckwheat. Such a policy would tend to stimulate more production and lower market prices than would occur without the subsidies. Estonia and Latvia could argue that this provides advantage to Lithuanian processors by lowering their raw material prices. That could be part of the explanation for lower cattle and milk prices in Lithuania, except that the same was true before these policies were introduced.

Conclusions

We have tried to identify issues and difficulties that are likely to arise in the implementation of the BFTA for agriculture. Some of these, especially related to differing national policies and interpretations of the agreement, can be reduced by harmonizing standards and customs regulations and clearly defining safeguard clause mechanisms and dispute settlement procedures. It is difficult to know the trade and price impacts of the agreement, but recent patterns suggest that Latvia has the highest prices for many products, which at early stages may stimulate increased imports from the member countries. Estonia may have an advantage as an intra-regional exporter of processed products because of the tariff-free imports of raw materials and the relatively advanced levels of processing facilities and higher foreign investment. While this advantage would be constrained by the rules of origin requirements, arbitrage will be hard to control. Lithuania has the largest production and consumption base and may be able to take advantage of economies of scale if the private sector is not hampered by government intervention.

There is no doubt that all three countries could benefit from this agreement if it is allowed to establish a true free trade area for agriculture. It has a limited potential to increase trade among the members and displace trade with nonmembers. However, it will take a lot of discipline on the part of the three governments to avoid actions that would subvert the spirit of the BFTA.