

Estonia's Changing Trade Patterns with China and Japan from 1993-2012

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ABSTRACT

In this thesis, the focus is on the trade relations between Estonia and selected Asian countries based on their importance, aiming to identify the current trade flows, changes within them over time and the reasons behind these changes. Furthermore, the comparative advantage of Estonia in relation to those countries should be revealed. The main research question is how the trade flows have changed and what factors are causing these changes since Republic of Estonia regained its independence in 1991. Mixed methods were applied to this research. Quantitative methods such as descriptive statistics were applied to establish the trade flows and their characteristics. Qualitative methods were used to analyse the foreign trade policy and events that have likely had impact on trade relations.

Major change in trade flows took place around the turn of the century, when China and Estonia joined the WTO. In 1993, trade between Estonia and China was based on comparative advantage; however, it is now very much based on intra-industry trade where both countries/partners trade similar articles with each other to meet the demands of their consumers. Trade between Japan and Estonia was and still is based on comparative advantage although Estonian goods exported to Japan have changed, whereas Japanese comparative advantage lies where it used to be.

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1. Introduction

Though Asia might be geographically very far away from the Republic of Estonia, their economies are more and more intertwined in the global world – people in Estonia are using products, services and materials from Asia every day without actually acknowledging it. Asian countries have become more important on the global scene, thus making it natural to shift the focus to that region. It is not only the production that is taking place there, but Asia is also emerging as an enormous market. Every foreign market is of great importance to Estonia and the businesses in the country have the ability to create niche products for exporting. While doing so, Estonia itself is more open to imports from Asia.

Many other European countries had established noteworthy relations with East Asian countries much earlier, often in the form of colonial relations, but Estonia has a relatively short history of international and economic relations with the Asian countries. For historical reasons the Republic of Estonia only had the possibility to establish those relations for a very short period of time between the 1st and 2nd World War and after 1991, the year in which it regained the independence from the Soviet Union. Given the rather short history of independent Estonia, the small size of the country and its geographical location, plus the fact that during the first independence of Estonia (1918-1940) there were not many independent countries in Asia itself, the relatively weak and new ties between those countries can be explained.

Nowadays, promoting economic relations with Asian countries has become one of the priorities for Estonia's Ministry of Economic Affairs and Communications (hereafter MEAC) that has worked out the Asian Strategy for Estonia to attract Asian tourists and enhance the exports to the emerging markets in the Asian region (MEAC, 2012). However, since Estonia joined the European Union, most of the decisions concerning foreign trade and trade agreements are being made jointly in Brussels now, not independently by the Estonian government, which is therefore constrained in pursuing its foreign trade policy.

1.1. Research Problem

Before being accepted to the EU in 2004, Estonia had become an open economy with very low trade barriers, if any at all. By joining the European common market, Estonia's economy – which is very much directed to that market precisely – benefitted a great deal, but this step simultaneously had implications to the trade with partners outside of Europe, as trade restrictions to non-European countries were imposed. A lot of production is located in Asia, thus importing from that region became more difficult. Asia in general and China in particular has a growing importance in the world. Despite imposing trade restrictions to Asian countries, their importance as trading partners for Estonia has grown significantly.

1.2. Aims and Objectives

The aim of this research is to identify and understand the reasons for the changes in the trade flows between Estonia and selected Asian countries. Furthermore, the comparative advantage of Estonia in relation to those countries should be revealed. Above all, it might also be possible to foresee some of the changes taking place in the future.

Neither trade nor political relations between Estonia and Asia have been researched yet on the academic level. In addition, the significance of this research lies in its practicality – it is not solely valuable to the Ministry of Economic Affairs and Communications of Estonia and policy makers, but it also can be of importance to other state institutions, business sector and also organizations engaged in the research and development. Beyond that, it could be useful for the same institutions in other Baltic states due to the similarities between the economies of the Baltic countries.

1.3. Previous Research

Most research about Asia in Estonian universities is focused on the culture and language of the different countries in that region and the little analysis conducted about trade, has been done by the Ministry of Economic Affairs and Communications and the Ministry of Foreign Affairs in the form of compendious articles. In addition, given the small size and distant location of Estonia, it is not of big interest to Asian researchers either.

The research on Estonia's foreign trade relations and trade policy in general is not that extensive at all. Feldmann and Sally (2002) look at the trade policy of Estonia from 1991 to 2000 and they argue that the influence of the European Union in particular on various aspects of national policy grew during that period as a result of the EU accession process – given that Estonia's goal, ever since the restoration of independence, was to join the EU, it had to comply with the EU regulations and, therefore, move away from its policy of unilateral free trade towards imposing trade barriers to third countries. Likewise, according to Laaser and Schrader (2002) the rearrangements of Baltic states' trade relationships that took place in the 1990s can be attributed to different mutually interdependent determinants, for example, stepwise integration into the EU markets, closer ties with other Baltic Sea states, historical trade relations from pre-Soviet occupation time, and the general globalization tendencies enhancing trade diversification. They point out that history still plays a special role for current Baltic trade relationships which explains the present-day strong ties among them, but also suggest that the trade flows of Baltic states with the rest of the world are starting to develop along the usual lines.

In addition, Paas (2000) has analysed foreign trade flows between Estonia and its main trading partners such as the countries in the Baltic Sea region and Germany, using the gravity model. Similarly, Fainštein and Netšunajev (2010) have focused on the development of foreign trade flows with the EU. Both studies conclude that the EU states – especially the nearby countries – are the most important trading partners to Estonia, therefore supporting their gravity model assumptions.

Since Estonia is a member of the EU, trade policies and relations of the latter play a crucial role. A number of recent researches about trade relations between the EU and Asian countries focus on the negotiations of free trade agreements. Nicolas (2009) and Park and Yoon (2010) discuss the EU- South Korea free trade agreement and the reasons why it had not become a reality yet, whereas Gavin and Sindzingre (2009) look at the trade interdependence between the EU and emerging Asia and the need of deeper integration through FTAs. Reiterer (2009) takes a closer look at the Asia-Europe Meeting (ASEM) and argues that it could play a useful role on the macro-economic level as ASEM could provide an additional stabilizing function when economic international competition strengthens due to the continuous rise of China. Likewise, Pakpahan (2010) examines the economic relationship between the EU and Asia and

states that future agreements are likely to favour Europe, unless these initiatives include the developmental aims for Asian countries.

Erixon et al (2010) analyse China's trade policy and commercial relations with the EU, expressing doubt that a preferential trade agreement would be signed between the two, as its discriminatory effects would be potentially trade-diversionary and dangerously system-fragmenting. The EU considers that China has benefitted unfairly from their economic relationship and it desires a more balanced one, but also is ready to use protectionist policies if necessary (Bustillo and Maiza, 2012). According to Qingjiang (2012), China's selection of partners for FTA signing and negotiations seems rather random, as the top three trading partners of China – the EU, Japan and the US – are not on the list.

As for Japan, the EU has had rather good and stable relations with this country for some decades. Pasierbiak (2009) demonstrates that in the period between 1995-2008 mutual trade ties between the EU and Japan weakened, due to, for example, the overall situation of the world economy, multilateral trade liberalization, economic situation of both parties involved, and different policies in the EU and Japan. According to Urata (2009), compared with ASEAN countries, the East Asian countries such as China, Japan, and South Korea have until recently taken a more passive approach to FTAs, however, their approach has changed over the past several years. In 2011, the leaders of the EU and Japan decided to start negotiations for a deep and comprehensive free trade agreement that seems to be following a trend which is going on elsewhere, as the number of FTAs in negotiation process or signed has risen significantly in the world (Söderberg, 2012).

To summarize, previous research about Estonian foreign trade has been focusing mostly on trade links with European countries. As Asia is such a distant region, not much attention has been given to it so far in academia. In addition, given the size and population of Estonia, it is not such an important trade partner to Asian countries to be researched in any of these either. There is, therefore, a vacancy for this research and the need to fill that gap, as the empirical research of this kind can be useful to policy makers.

1.4. Preliminary Findings

Based on the previous research, the following preliminary findings concerning the research problems have been found:

- The most important trading partners for Estonia are European countries located nearby whom it has historical relations with.
- Accession to the European Union changed Estonia's foreign trade policy to a great extent.
- Estonian future possible free trade agreements with Asian countries will be signed in the framework of the European Union, not independently and bilaterally.

1.5. Research Questions

In this thesis, the focus is on the trade relations between Estonia and selected Asian countries based on their importance, aiming to identify the current trade flows, changes within them over time and the reasons behind these changes. The main research question is how the trade flows have changed and what factors are causing these changes since the Republic of Estonia regained its independence in 1991.

The second step is to find out the reasons behind the changes in trade flows by looking how political events can change trade. In order to do so, following sub-questions will be answered:

- What is the general trade policy of Estonia?
- Which free trade agreements has Estonia signed and which trade barriers impede trade?
- How did joining the World Trade Organization and European Union influence trading with selected Asian countries?
- Which factors within the biggest trading partners in Asia have had influence over the trade patterns and how?

1.6. Disposition of Thesis

The remainder of this thesis will be structured into five chapters. Firstly, methodological considerations are outlined in the second chapter. The third chapter deals with the theoretical

framework of the research by elaborating on the theoretical perspectives from economics and international political economy. Forth chapter discusses Estonian foreign trade policies from regaining its independence in 1991 and the change within these. Estonia's trade patterns with Asian countries are lined out in the fifth chapter, followed by an in-depth analysis of how trade relations with biggest trading partners in Asia – China and Japan – have evolved and trade patterns changed over time. The final conclusive chapter summarizes main findings and gives concluding remarks.

2. Methodology

Mixed methods were applied to this research. Quantitative methods such as descriptive statistics were applied to establish the trade flows and their characteristics. Qualitative methods are used to analyse the foreign trade policy and events that have likely had impact on trade relations.

2.1. Data Collection

Suitable data sources for this research are the official foreign trade statistics and foreign trade policy papers. The advantage of using official statistics is that the data have already been collected, and in the case of trade, it is not based on samples, which makes it possible to obtain the complete picture (Bryman, 2012: 320). Also, it is possible to give a historic overview since the foreign trade statistics of Estonia date back to 1993. Besides, documents such as policy papers, countries' overall economic overview and statistical records were collected from open databases, for example from Statistics Estonia, the Ministry of Economic Affairs and Communications, the Ministry of Foreign Affairs, and variety of international online databases.

The first set of data used is official trade statistics of Estonia. For the sake of comprehensiveness, general export and import numbers are used instead of special trade data. The research is limited to a 20-year period from 1993 to 2012, due to the available data, as the data on foreign trade statistics for Estonia are available only from 1993 onwards. Prior to the accession of Estonia to the European Union, custom declarations were the base for all foreign trade statistics up until 2003. From 2004 and thereafter, foreign trade statistics are based on two data collection systems – Intrastat and Extrastat (Statistics Estonia, 2013). Moreover, additional data has been collected from Eurostat database, which presents data of the European Union foreign trade as a whole and also by member states.

In addition to statistical data, the state is the source of a great deal of textual material (Bryman, 2012: 549), therefore, the second set of data used are documents reflecting the changes in the trade flows between Estonia and its major Asian partners to contextualize trade relations. These include, for example, documents concerning Estonia's accession to the European Union, different economic agreements with Asian countries, and membership in the

World Trade Organization, as these events have changed Estonia's foreign trade policy. Furthermore, the European Union Common Foreign Trade Policy documents issued by the European Commission and research relating to foreign trade policy have been used. However, policy documents, for instance, raise the question of credibility and impartiality. To avoid using only official materials issued by states that might be biased, previous academic research on Estonian, Chinese and Japanese foreign trade in general will be used as an additional source of data, since there is no research conducted on trade relations between Estonia and Asia specifically.

2.2. Methods Used

In this research, the focus lies upon the trade relations between Estonia and selected Asian countries.

To map that general trading pattern, the export and import structure since 1993 were analysed in Microsoft Excel using the data gathered from Statistics Estonia and Eurostat databases. The analysis of official statistics may be viewed as a special form of secondary analysis (Bryman, 2012: 327). Upon establishing the quantity of trade, two most important Asian trading partners for Estonia over the twenty years under examination were revealed and explored in depth. Furthermore, the current trends in the trade relations between Estonia and major trading partners in Asia were identified to establish the most relevant trade articles. In addition, the use of descriptive statistics and secondary data analysis gives an overview of trade relations in question, and graphs and tables constructed in MS Excel have helped to illustrate and explain these trade flows – increases and decreases in both exports and imports are being shown.

To understand which factors have influenced the trade relations between Estonia and selected Asian countries, certain events such as Estonia joining the EU in 2004 have to be taken into account. Also, both Estonia's and Asian countries' membership in WTO is likely to have an impact on the trade, which, therefore, will be examined as well. In addition, bilateral economic agreements signed since 1991 with major Asian trading partners will be scrutinized to explain changes in trade articles and/ or volumes prior to the accession of Estonia to EU. In

order to establish the changes in trade flows, documents and papers dealing with those above-mentioned events will be analysed.

By combining the statistical data with the document analysis, the aim is to explore the trade flows and to establish the factors that have had impact on trade patterns in the last twenty years. It might also be possible to predict likely trends in trade flows after that, but this is not the main focus of this research.

3. Theoretical Framework

3.1. Classical Trade Theory – the Ricardian Model

Countries engage in international trade for two main reasons – firstly, they differ from each other in their resources and/or in technology and can thus benefit through trade, and secondly, to efficiently manufacture the goods they are able to produce the best. Probably everyone agrees that some international trade is beneficial – it gives access to products and goods that cannot be grown or produced locally, like tropical fruits in northern parts of Europe in winter time, for instance. Trade also enlarges the range of choice, giving the residents of each country more options, therefore benefitting the people.

In the 19th century, the English economist David Ricardo proposed a model of international trade and introduced the concept of comparative advantage in his “Principles of Political Economy and Taxation” in 1817, which has become a cornerstone of international trade theory. According to his approach – known as the Ricardian model – international trade is happening because of the differences in the productivity of labour. A country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries (Krugman et al, 2012: 56). In other words, if a country could produce something more valuable with the same resources that are being used to produce a good, then it should import this product, free up the resources, and focus on producing more valuable goods instead.

Yet, the Ricardian model can make some misleading predictions, such as an extreme degree of specialization, that differences in resources play no role as a cause of trade, and that countries as a whole will always gain from trade. However, the very basic prediction of the Ricardian model – when trade is free, countries should tend to export those goods in which their productivity is relatively high – has been strongly confirmed by a number of studies over the years (Krugman et al, 2012: 75) and has not forgone its relevance even today.

3.2. New Trade Theory

However, it became obvious in the 1970s that not all features of international trade were that well explained by any comparative advantage based theory (Neary, 2009: 219). Based on the

“old“ trade theory, countries trade because they are different – they have different resources, they differ in productivity in particular industries, for instance. Dissimilar goods are being traded between different countries, according to their comparative advantage. Countries in tropical climate can grow and export tropical fruits, whereas countries in colder climate grow and export wheat; a state with highly educated labour force can produce and export high-tech goods, whereas a country with less educated labour produces and exports simple manufactured goods. In other words, the old theory anticipated that international trade involves exchanging different goods and should be larger the more countries differ from each other in terms of relative production possibilities. Even though this explains a lot of international trade, it also misses quite a lot – countries with similar climates and resources trade with each other more than the classical trade theory would presume. Krugman (2008: 335-336) calls it the similar-similar problem – exchanges of similar products (manufactures) between similar countries (developed ones) play a huge role in world trade after World War II. Empirical work from the 1970s showed that a high proportion of trade took place within industries rather than between them (Neary, 2009: 219), which needed scientific explanation. As Helpman and Krugman (1985) put it, the empirical weakness of classical trade theory becomes obvious when economies of scale and imperfect competition are introduced into the analysis.

Therefore, in the late 1970s and 1980s, the new trade theory was presented. With this theory, the economists were trying to make sense of this similar-similar trade, since the Ricardian model was far too simple to be a full explanation of either the ground for or the effects of international trade. Therefore, several new factors were added over time – increasing returns to scale, differentiated products, technology, and geography.

Krugman, who is generally viewed as one of the founders of the new trade theory, wrote a paper in 1979 which introduced probably the simplest possible fully-specified general-equilibrium model in which intra-industry trade could be rigorously demonstrated (Neary, 2009: 220-221). He based one of his works (Krugman, 1981) on Balassa’s research from 1966 which had analysed the effect of European Common Market on income distribution and found that the trade liberalization had taken the form of intra-industry specialization. Krugman (1983) then introduced the factor of technological competition in the trade between industrialized countries, which suggests that in some manufacturing sectors countries might be tempted to engage in protectionist or interventionist policies. Eaton and Kortum (2002)

developed the Ricardian model further to incorporate a role of geography and their model delivers equations relating bilateral trade around the world to parameters of technology and geography. Building on Eaton's and Kortum's work, Costinot et al (2012) quantified the importance of the Ricardian comparative advantage at the industry level and estimated the impact of productivity differences on the pattern of trade across countries and industries without having to rely on the limitations of the existing empirical Ricardian literature, such as bilateral comparisons of a two-country model, for example.

Whereas the classical trade theory is supply driven, the new theory is demand driven and can account for the type of intra-industry trade that marks much of the pattern of trade among the world's wealthier countries (Hanink and Cromley, 2005: 511), as consumers are seeking for variety in products. Similar countries had little comparative advantage with respect to each other, so their trade was dominated by intra-industry trade caused by economies of scale (Krugman, 2008: 338). Each country is still a net exporter in certain industries in which it has a comparative advantage, but due to the intra-industry specialization, they will also import some products in which it is a net exporter, and vice versa (Krugman, 1983: 344). Therefore, there will be both intra-industry and inter-industry trade between countries. In addition, the more similar the countries are, the more intra-industry trade takes place between them.

Krugman (1981) showed with his model that trade liberalization hurts scarce factors only if comparative advantage was strong and/or economies of scale weak; however, in the reversed case that described the growth of trade among industrialised countries, trade was beneficial for all parties involved. In addition, by adding the transportation costs to the model, it became obvious that countries would tend to become exporters in the industries in which they had a large domestic market (Krugman, 2008: 339). Because of the increasing returns, it is profitable to concentrate the production in a single location; transport costs can be kept down by choosing a location near the biggest market, with this location then exporting products to other markets further away. By the mid-1980s, the new trade theory had integrated increasing returns more or less seamlessly into our understanding of international trade (Krugman, 2008: 340).

3.3. Free Trade Theory

The desirability of free trade is something that most academic economists have commonly advocated. The broad argument for free trade, to which many economists implicitly subscribe, is essentially political: free trade is a pretty good if not perfect policy, while an effort to deviate from it in a sophisticated way will probably end up doing more harm than good (Krugman, 1993: 364). The idea of free trade also has its roots in the Ricardian model - trade between two countries can benefit both countries if each country exports the goods in which it has a comparative advantage (Krugman et al, 2012: 56). Complete freedom of trade, then, enables countries to discard their less valuable industries and focus on production in their most valuable ones. Therefore, the theory of comparative advantage sees international trade as an immense interweaving system of trade-offs, in which countries use the possibility to import and export in order to cut opportunity costs and rearrange their factors of production to meet their most valuable uses.

According to the classical cost-benefit analysis, a small country is better off without applying tariffs as no unilateral action by such a country can affect the international prices at which it trades (Kowalczyk, 2008: 420), therefore, it is only hurting its own residents by imposing tariffs. In the case of a small country then, it cannot use tariffs to raise its terms of trade (Krugman et al, 2012: 279). Free trade, on the other hand, increases national welfare because lifting the tariffs and lowering the price benefit domestic consumers. In addition, some economists argue that the need to deter excessive entry and the resulting inefficient scale of production is a reason for free trade (Krugman et al, 2012: 251). It is commonly held viewpoint that a small country benefits more from free trade than a large one (see for example Ray, 1977; Casella, 1996; Deardorff, 2011; Krugman et al, 2012).

However, very few countries actually have anything similar to completely free trade. If the idea of gains from trade is the most important theoretical concept in the international economics, the seemingly never-ending debate over how much trade to allow is its most important policy theme (Krugman et al, 2012: 35). Most countries have applied restrictions in some form to foreign trade. According to Deardorff (1987: 193), the rationales for restricting trade vary – from the use of tariffs to improve the terms of trade, to second-best policies for dealing with domestic distortion, to the use of trade policy to divert monopoly profits toward domestic residents or government. Though tariffs are the simplest trade policies, most

governments in the modern world use other forms of intervention – import quotas, export subsidies, voluntary export restraints, and local content requirements (Krugman et al, 2012: 232). Trade intervention is rather defensive in its nature – trade barriers are very often set up due to internal pressure to protect domestic producers, exporters, and workers.

The world has seen a general trend toward freer trade from World War II onwards, which was achieved through international negotiations – governments agreed to reduce tariffs mutually. Lowering tariffs as part of mutual agreement helps mobilize support for freer trade, but also helps to avoid a trade war (Krugman et al, 2012: 265). The World Trade Organization, or WTO, was established in 1995 to monitor and enforce the General Agreement on Tariffs and Trade (GATT), which is now the central institution of the international trading system and advocate for the trade liberalization. However, the most recent major round of trade negotiation – Doha round – has not been as successful as the previous ones, partly because the remaining barriers are fairly low, so that the potential gains from further trade liberalization are modest (Krugman et al, 2012: 273).

While the process of multilateral liberalization proceeds at a very slow pace, recent years, however, have seen much liberalization in different forms of preferential market access agreements, such as free trade areas or customs unions (Kowalczyk, 2008: 417), the European Union being the most notable one. Taken individually, the EU countries are very open economies, as they have removed all tariffs with respect to each other – there are no tariffs or import quotas on intra-European trade. However, as a customs union, the EU imposes collective trade barriers to other countries.

In a world where trading blocs can be formed, a small country can do better by signing a free trade agreement with a large country than with unilateral free trade, whereas the large country's welfare suffers no loss from integrating with a microstate or with a country that is almost the same size as the large country (Kowalczyk, 2008: 418). Because a small country is unable to affect the world prices, the large country's domestic prices will also remain unaffected once it engages in bilateral free trade with a small partner. When a small country signs a preferential trade agreement, for instance, with a larger country, the smaller one can buy all it wants from the larger one at the world price, gaining from the trade exactly as if tariffs on all imports had been removed, while at the same time allowing its exporters to sell in the partner country at the higher tariff-protected price (Deardorff, 2011: 133). At the same

time, imports from the small country capture a part of the larger country's market, depriving its government of tariff revenue, without pushing down the price in that market; while demanders buy only part of its exports, leaving its suppliers dependent on the world market (ibid). Size, therefore, matters for finding a partner for a trade agreement.

4. Estonian Foreign Trade Policies

4.1. Historical Background

Estonia had been incorporated into Soviet Union in 1940 which also meant establishing the Soviet economic system with five-year-plans directed from Moscow according to the needs of the Soviet Union. During the occupation period, agricultural production was re-organized into collective farms and over-industrialization forced, which was accompanied by massive industrial growth. The most important characteristics of Soviet Estonia's economy were a large proportion of manufacturing and agriculture, and a low level of infrastructure, service and trade sectors (Estonica, 2012), which reflected the Soviet economic structure as a whole. However, because Estonia is lacking its own natural resources, the industry and production in that time was built upon imported crude materials according to the Soviet Union's needs. Raw materials and supplementary parts came from different Soviet republics and an output of low-quality mass production was delivered back to those regions. The strongest emphasis lay on the oil shale industry, and the machine-building and construction material industries (Klesment, 2009: 253), but production of textiles and foodstuff was also an important part of the economy. Industrial products as well as foodstuff were exported according to plans despite a shortage of these products in the local Estonian market (Klesment, 2009: 255). Until restoring its independence in 1991, the Estonian economy had been serving the needs of Soviet Union instead of its own by manufacturing chemical products, heavy machinery, textiles and agricultural products.

Estonia's foreign trade was directed toward integration with the Soviet market (Hoag and Kasoff, 1999: 920) and relations with Western markets were almost non-existent. However, according to Feldmann and Sally (2002), radical trade and investment liberalization in Estonia during the first half of the 1990s, combined with the collapse of the Soviet economic system and other reforms, brought about a rapid shift in Estonia's trade and foreign direct investment geography – the importance of the European market grew abruptly. Having a small domestic market makes Estonia heavily dependent on foreign markets, which is why exports and good foreign relations matter a great deal to Estonia. The goal of Estonia was to be re-integrated to West and distance itself from Russia and other former Soviet republics, both politically and economically.

In addition, the industry underwent dramatic structural changes during that period – a remarkable decrease had taken place in the share of manufacture of food products, textiles, and chemical industry, whereas wood industry and manufacture of basic metal and fabricated metal products have grown considerably (Statistics Estonia, 2010: 36), as this is where Estonia's comparative advantage lies. However, primarily due to various forms of subcontracting, engineering products and machinery still play the most important role in Estonian exports, next come timber and various products made of timber (Estonica, 2012). Also, the state emphasized the need for educated highly skilled labour force which is necessary to develop knowledge-intensive service-based export-oriented economy, and started a nation-wide project called Tiigrihüpe in 1996 through which the government invested and developed computer infrastructure and IT education (Tiigrihüpe, 2013), in order to catch up with the West technology-wise as fast as possible.

4.2. Moving Towards Free Trade in 1990s

Upon restoring its independence, Estonia made a bold and abrupt shift towards the market economy and unilateral trade liberalization, following the general opinion of the economists that a small country benefits from free trade to a great deal, as it is unable to affect the international prices by applying tariffs. Former state monopoly in trading was abolished and no restrictions on imports and exports of goods were set up as a way to improve the competitiveness of domestic industries. Trade reforms taken in the early 1990s shifted the economy from highly protected command economy to almost complete free trade like Hong Kong, which set Estonia apart from other reforming countries in East Central Europe at the time, like Poland, the Czech Republic and Hungary (Feldmann and Sally, 2002: 79). Currency reform, fiscal reforms, extensive privatization and introduction to unilateral free trade were followed by the structural transformation of the economy, as Estonia started to discard its less valuable industries to focus on more valuable ones.

Substantial unilateral trade-and-investment liberalization has taken place outside the OECD area since the 1980s, but none of the numerous Latin American, East Asian and East European countries have gone as far as Estonia (Feldmann and Sally, 2002: 83). Estonian government decided to remove tariffs on all imports, which also included agricultural goods – a noteworthy feature of its trade policy reform, since many other countries keep their

agricultural sector protected. In addition, non-tariff barriers were also removed, as import quotas dating back to Soviet central planning time were abolished in the beginning of 1990s. The average weighted tariff was 1.4 per cent in 1993 and went down to zero in 1997, making Estonia's trade policy regime the most liberal in Europe at that time (Feldmann, 2003: 521-522).

The unilateral trade liberalization took place first, followed by free trade agreements with other countries and economic blocs. The maxim of then-Prime Minister Mart Laar was acted on: "Liberalize, then negotiate; but don't negotiate and then liberalize." (Feldmann and Sally, 2002: 90). Starting from the mid-1990s, Estonia shifted from unilateral free trade policy that had been followed at that time to a trade policy pursued more vigorously on other tracks - FTAs with a widening range of trading partners on bilateral level, negotiations with the WTO on multilateral level, and negotiations with the EU on the regional level (Feldmann and Sally, 2002: 94). FTA with Latvia and Lithuania was signed in 1994, the one with European Communities entered into force in 1995, and several other FTAs with European countries were signed during the 1990s (WTO, 1999: 37), all signed only after unilateral liberalization. However, a FTA with Russia never happened because Russia continuously refused Estonia a most favoured nation treatment (Feldmann and Sally, 2002: 95), although Russia has been a very important trading partner for Estonia.

On multilateral level, negotiations for WTO accession started in 1994 and were successfully completed in 1999 when Estonia was accepted as a full member state. What set Estonia apart from previous accession negotiations was that, unlike other candidate states, Estonia wished to bind tariffs in the WTO above applied rates of 0 per cent in preparation for EU accession (Feldmann, 2003: 522). It was the first time that a candidate country that already had applied zero tariffs at the time of the negotiations wanted to bind tariffs at much higher level.

The Estonian government was determined to join the EU and, therefore, regional trade policy became the priority of foreign economic policy. After signing the FTA with the European Communities, Estonia applied for EU membership in 1995. For that reason, Estonia had to start making adjustments to its trade policy to meet the conditions of common trade policy of the EU and forsake its very open and liberal trade policy. This unilateral free trade era came to an end in January 2000, when Estonia started levying most favoured nation tariffs on agricultural imports from third countries, which it did not have signed FTAs, although until

the accession to the EU, non-agricultural goods were still subject of no tariffs (Feldmann, 2003: 524).

4.3. De-liberalization Period from 2000 onwards

After about a decade of truly free trade, Estonia had to adopt the Common Commercial Policy upon its accession to the EU, which meant letting go of its former free trade policy. It brought along free trade and free movement of capital, goods and labour among the EU member states, but on the other hand, it also meant the beginning of more restricted trade in regards with the rest of the world. Not only was Estonia required to impose tariffs, but several other measures, such as quotas, export subsidies, and export restraints etc., to trade with third countries were applied. In addition, the decision making process changed significantly – until 2004, the Estonian Ministry of Foreign Affairs was responsible for designing and executing trade policy, in cooperation with the Ministry of Economic Affairs and Communications and the Ministry of Finance. However, after joining the EU, it is the European Commission in Brussels that has the control and authority over foreign trade policy, as individual states no longer have the power to negotiate and conclude foreign trade agreements, and Estonia follows the common EU foreign trade policy.

Thus, it can be argued that the main attraction of EU membership did not lie in trade policy, but was seen primarily in terms of security, and perhaps related to other aspects of economic policy (Feldmann and Sally, 2002: 102), as Estonian unilateral free trade was not harmonious with EU rather protectionist trade policy with third countries. Both Fraser Institute and Heritage Foundation have indicated some decrease of economic freedom of Estonia during first years of EU membership (Raig, 2008: 155).

Although the EU has imposed trade restrictions to third countries, it is still in favour of liberalizing international trade in general. The EU has been actively negotiating and promoting preferential trade agreements (PTAs) in several different forms – unilateral, bilateral, or regional agreements – in addition to the WTO negotiations. The EU has created a wide network of PTAs and extending it even further could also increase Estonia's trade with third countries in the future. As a result of its widespread PTAs, the EU trades with only ten WTO members where the most favoured nation regime applies in its entirety, including China

and Japan (Ahearn, 2011: 423). Given the distance of Asia, the EU's main objective with that region is to neutralize potential discrimination against EU exports and to secure commercial benefits for EU exporters (Ahearn, 2011: 431), rather than political and security objectives as with closer neighbours. Change in the EU's policy towards Asia took place in 2006, when the European Commission argued that a properly conducted trade policy can contribute to the EU's economic growth and jobs creation, and indicated ASEAN, China and South Korea as priorities (Pasierbiak, 2009: 469) due to their economic performance.

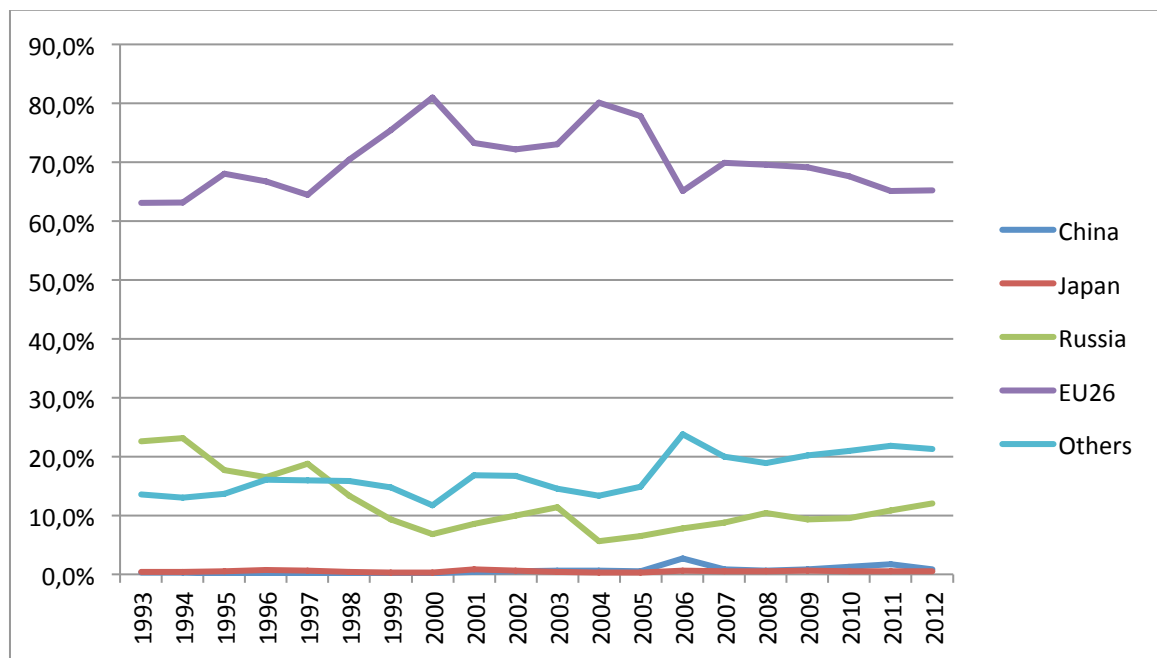
In 2011, the EU and South Korea signed an FTA which is the first agreement of that kind between the EU and an Asian country, however, negotiations with India are on-going and negotiations with Japan were opened in 2013 (European Commission, 2013b). Since ASEAN represents the EU's third largest trading partner outside of Europe, the EU would prefer to sign a wider regional trade agreement with it, but is currently negotiating FTAs with Singapore, Malaysia, Vietnam and Thailand separately (European Commission, 2013c), because of the differences within the ASEAN group. Signing FTAs with Asian countries will very likely enhance Estonia's trade relations with the region.

5. Estonia's Trade Patterns with Asia

5.1. Foreign Trade Flows

Only two years after restoring its independence, the European market¹ was the destination for over 60% of Estonian exports, which is a major change from almost no interaction back in 1990. Exports to Russia which used to be Estonia's main trading partner decreased throughout the decade, partly because of political reasons, partly due to the economic crisis in Russia in 1997. East Asia as a rather distant region maintained weak trading ties with a share of less than 2% of all Estonian exports. Akin to the time before joining the EU, European countries are still unquestionably the most important trading partners for Estonia in 2012. Their exports account around two thirds of all Estonian exports, peaking at an 80% level in the year of Estonia's accession to the EU. Trade relations with Russia are constantly altering, depending very much on its economic performance and political relations between two countries, whereas exports to Asia have kept a steady 2% mark. Exports to China fluctuate around 1%, compared to exports to Japan that are rather stable at 0.5% in recent years.

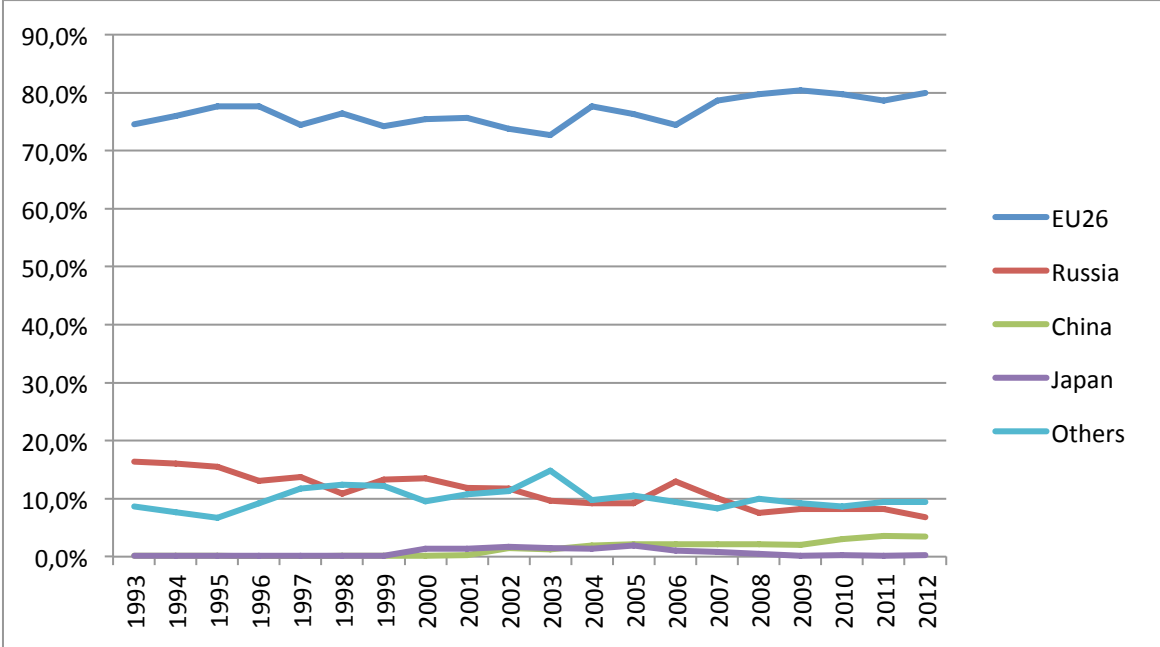
Graph 1: Share of Estonia's exports 1993-2012 (Source: Statistics Estonia, 2013)



¹ 26 European Union member states, excluding Estonia: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Russia: It is individually important, therefore listed separately

Similar to exports, imports are greatly dominated by European countries, maintaining a steady share of three quarters of all Estonian imports. As was with exports, Russia and Commonwealth of Independent States (CIS11) lost the majority of their importance due to Estonia’s reintegration to West, whereas imports from East Asia tripled in a year after Estonia was accepted to WTO rising from 1% in 1999 to 3% in 2000. Furthermore, Asia now accounts almost 6% of all Estonian imports, regardless of the trade barriers with the region. About 3% of all Estonian imports come from China, but only 0.2% from Japan. With that, those two countries are the most important trading partners in Asia for Estonia, similarly to the whole EU.

Graph 2: Share of Estonia's imports 1993-2012 (Source: Statistics Estonia, 2013)

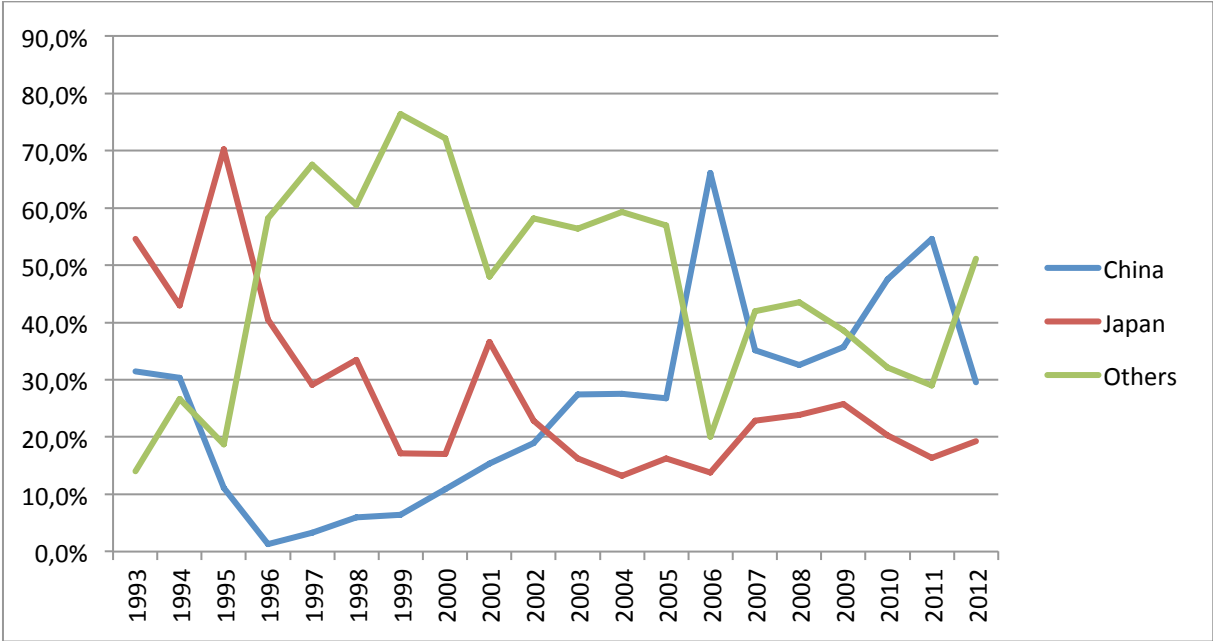


In general, trade flows between Estonia and different Asian countries have been quite uneven and altered significantly from year to year. The share of exports to Asian countries constituted 2.7% of the total Estonian exports in 2012, staying on a rather stable figure recently, whereas imports from Asia have risen to almost 6% over time. One reason behind that relatively low level of trade with Asia can be explained by long distance and consequent trade costs. If trade costs matter, then almost certainly location also matters, since many trade costs are increasing in distance (Deardorff, 2005: 170). It is therefore simply more expensive to trade with countries located further away – geography matters a lot in economics. Put differently, trade diminishes dramatically with distance and prices vary across locations, with greater differences between places farther apart (Eaton and Kortum, 2002: 1741), which applies well

to trade relations between Estonia and Asia. In addition, cultural differences, small size of the Estonian economy, and weak historical ties play their role too.

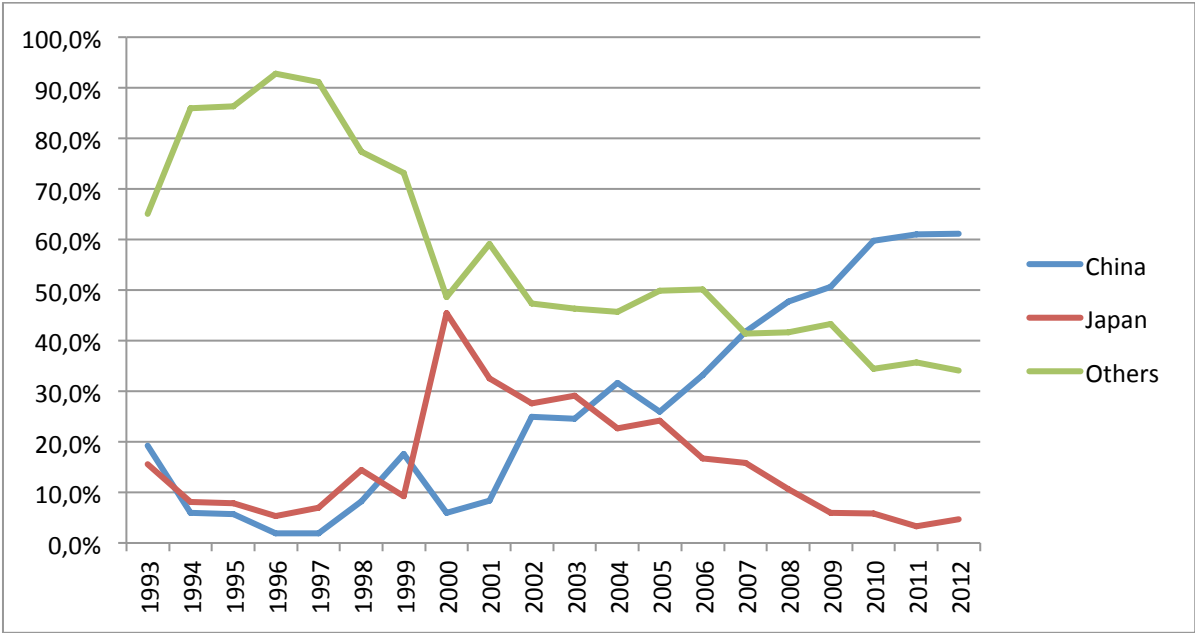
There are 21 countries in the Asian region that Estonia is or has been trading with over the past twenty years, yet a majority of them account for just a marginal share of Estonian trade flows. However, there are some states which stand out and represent a larger share of trade. For instance, China is 20th and Japan 22nd trading partner for Estonia now (Statistics Estonia, 2013), being even more important than some of the European countries with closer location and stronger historical ties. Furthermore, Japan, China and South Korea have been major trading partners in Asia for Estonia ever since it regained its independence, and even now, exports to the region are dominated greatly by exports to China and Japan, matching the general pattern of the EU27 trade.

Graph 3: Share of Estonian exports to Asia (Source: Statistics Estonia, 2013)



In the case of imports, the importance of Asian imports started to grow more rapidly from the year 2000 onwards. Imports from China rose quickly and imports from Japan started to decrease at the same time, a pattern still very much in place in 2012 when China’s share of imports from Asia accounted for a whole 61.2%.

Graph 4: Share of Estonian imports from Asia (Source: Statistics Estonia, 2013)



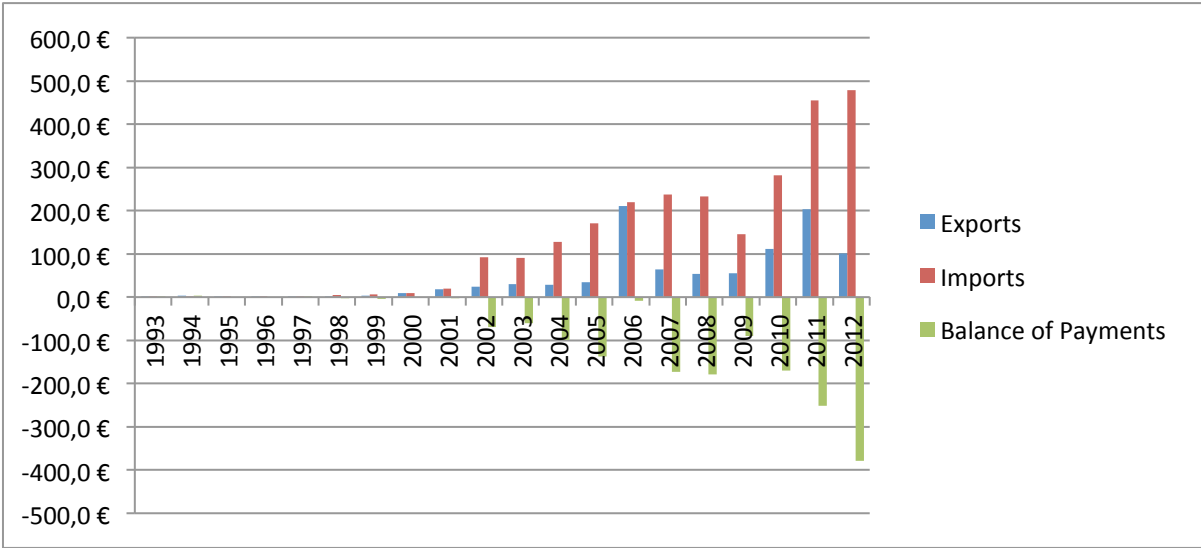
5.2. Trade Relations with China

China has become the most important trading partner in Asia for the EU as a whole and also for Estonia. Whereas just two decades ago, trade between the EU and China was minimal, today they are trading more than €1 billion every day (European Commission, 2013a). China is the EU's biggest source of imports by far with 16.3%, and has also become one of the EU's fastest growing export markets, accounting 8.3% of all exports, and in turn, the EU has become China's biggest trading partner (European Commission, 2013a). However, the EU-China trade runs a large deficit which reflects the massive reshaping of global trade flows and production networks in the past decade, with China acting as an assembly hub where inputs from other countries are put together to be re-exported (Erixon et al 2010: 60).

Trade relations between Estonia and China were almost non-existent in the beginning of 1990s; however, the development of these has been remarkable. Economic relations now are stable and good, but constrained by the distance and differences in size and cultures. Estonia's main interests in China include investment potential, the enormous market, a cheap production bases, and the possibility for contractor works. China's interests in Estonia include the advantageous geographical location, the EU and Euro-zone membership, good transportation infrastructure, and strong technical potential. One of the goals for Estonia is to

establish a distribution centre of Chinese products (MOFA, 2013), which would benefit Estonian economy and also infrastructure to a great extent, and which would at the same time help Chinese exporters to enter the European market and cut down transportation time. Estonia, however, is not an important export market for Chinese producers due to its very small size. Also, long distance between Estonia and China and consequent higher transportation costs hinder the development of even stronger economic ties.

Figure 1: Estonia's trade with China, million € (Source: Statistics Estonia, 2013)



Trade with China was of little importance throughout the 1990s, starting to take off only in the year 2000 and it has been growing rather steadily ever since. However, since the trade took off, Estonia has run a large trade deficit which is showing a growing trend, as imports from China exceed exports to China by a great deal. The only year during this decade when exports and imports were almost even was in 2006, when the trade deficit was very small.

As for the 1990s, the rather low level of trade can be explained by Estonia’s focus on the reintegration to the European market and China yet having to emerge as the world’s production hub. During the second half of the 1990s, trade growth in China slowed partly due to the impact of external events (the Asian financial crisis), partly due to the real appreciation in the RMB between 1994 and 1997, and partly due to the lack of dramatic progress in trade liberalization during that period (Naughton, 2007: 393), which also had an effect on trading with Estonia. In addition, Estonia was still trading mostly with Japan, South Korea, Hong

Kong and Taiwan at the time. Even so, as China started to become more open and home to more production, the trade relations expanded.

Most important change took place around the turn of the century when a sudden increase in both imports and exports happened – both countries had been accepted as members of WTO. All countries benefit from freer world trade, with small countries gaining more than big ones (Eatum and Kortum, 2002: 1742) as it is widely proven by previous research. In the standard two-country model, the small one benefits more as it can trade at the prices prevailing in the rest of the world before trade was opened up; however, the distribution of gains will generally be independent of the size of the country so long as there is universal free trade (Ray, 1977: 67). Estonia had already unilaterally liberalized its trade; therefore, it had more to gain from China's accession to the WTO as it meant fewer trade restrictions with China. If tariffs at home and abroad are low, then countries have more to gain by expanding exports through foreign tariff reductions than by expanding imports through tariff reductions of their own (Deardorff, 2011: 119). Thus, tariff reductions in China are the reason for the increase in Estonian exports after 2001.

As China entered the WTO at the end of 2001, it took the responsibility of running a series of liberalization commitments, including gradually lowering tariffs and abolishing quotas, but also extending trading rights without restrictions (Naughton, 2007: 377-390). Trade liberalization tends to make it more lucrative to locate production in countries with large home markets in order to utilize scale economies, and export to small countries (Kind, 2002: 151). China as an enormous market and cheap labour pool has proven to be such a case – a lot of production and assembling has been moved there recently, which explains the increase of Chinese exports to the world market.

China's accession to the WTO brought along a rise in both exports and imports compared to pre-WTO times, especially in trade of machinery and electrical devices (Statistics Estonia, 2013), as a notable increase in the manufacture of electrical equipment had taken place in Estonia (Statistics Estonia, 2010: 36) after the independence. Electronics parts were then exported to China to be assembled there, only to import final products later on.

5.2.1. Structure of trade

According to Eurostat (2013), most of the EU27 imports from China are machinery and transport equipment (50.2%), miscellaneous manufactured articles (29.9%), and manufactured goods (12.4%). Import of foodstuff and beverages, mineral fuels, and chemicals constitutes less than 8%. Likewise, the export of European countries to China is dominated mainly by machinery and transport equipment (58.5%), followed by chemicals (11.7%), manufactured goods (9.6%), and miscellaneous manufactured articles (7.7%). However, what the Chinese need from Europe is technology transfer in those areas where their own domestic capabilities are still weak, such as telecommunications, high-tech industry, IT, etc. (Hanso, 2012: 114).

The composition of trade between Estonia and China has changed over the years as both countries have developed and undergone a profound economic transformation from the beginning of 1990s. Due to that reason, they have moved up the value chain of global production, producing more sophisticated and diversified products now. In addition, both China and Estonia have successfully integrated themselves into the global division of labour.

In 1993, Estonia only exported machinery (60.7%) and a small amount of manufactured goods (39.9%) to China, whereas the most essential imports included food products and live animals (52.2%), manufactured goods (34.4%), and crude materials (5.1%). Trade was based on the comparative advantage – both countries exported goods that they could produce relatively effectively. Estonia was an exporter of vehicles and their parts, and some metals but instead of the former Soviet market that had collapsed, those products found a new market in China. China on its part, was exporting mostly livestock and wheat to Estonia. The comparative advantage for Chinese exports in the world market has changed a great deal – more and more exports have comparative advantage, most of which are low technology products (Wei and Chunming, 2012: 120). In addition, larger countries have more export diversification opportunities than smaller countries (Minondo, 2011: 515), which is why China has successfully become an exporter in a wide range of products. Similarly, Estonia has developed in fast pace and the export structure has changed, being slightly more varied now.

Figure 2: Estonia's exports to China by SITC section, 1993 (Source: Statistics Estonia, 2013)

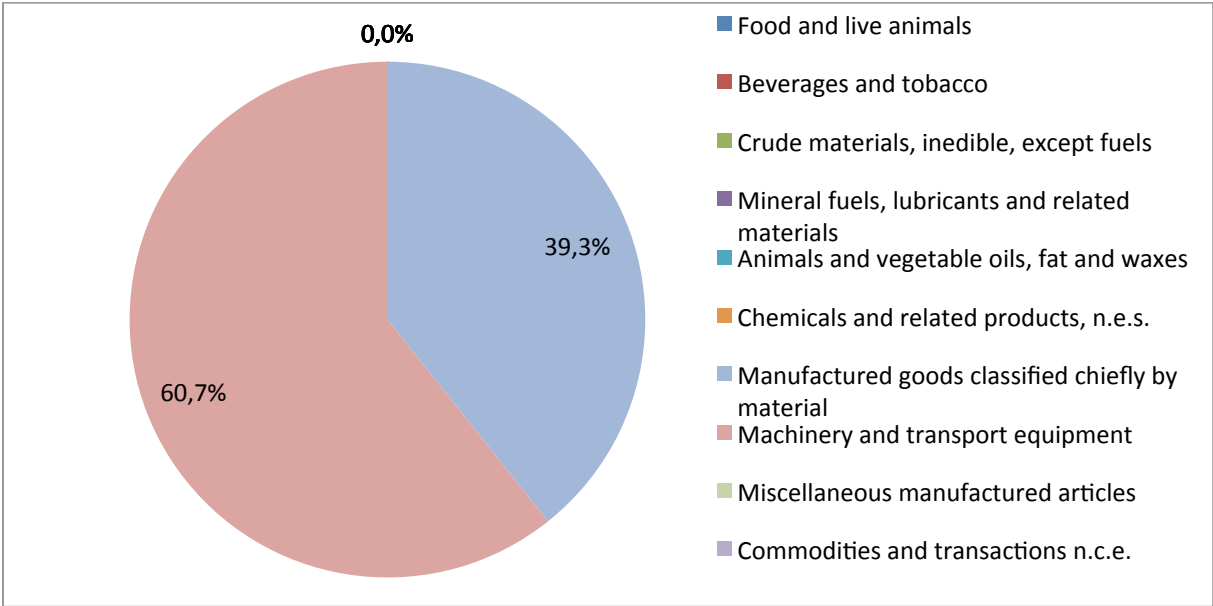
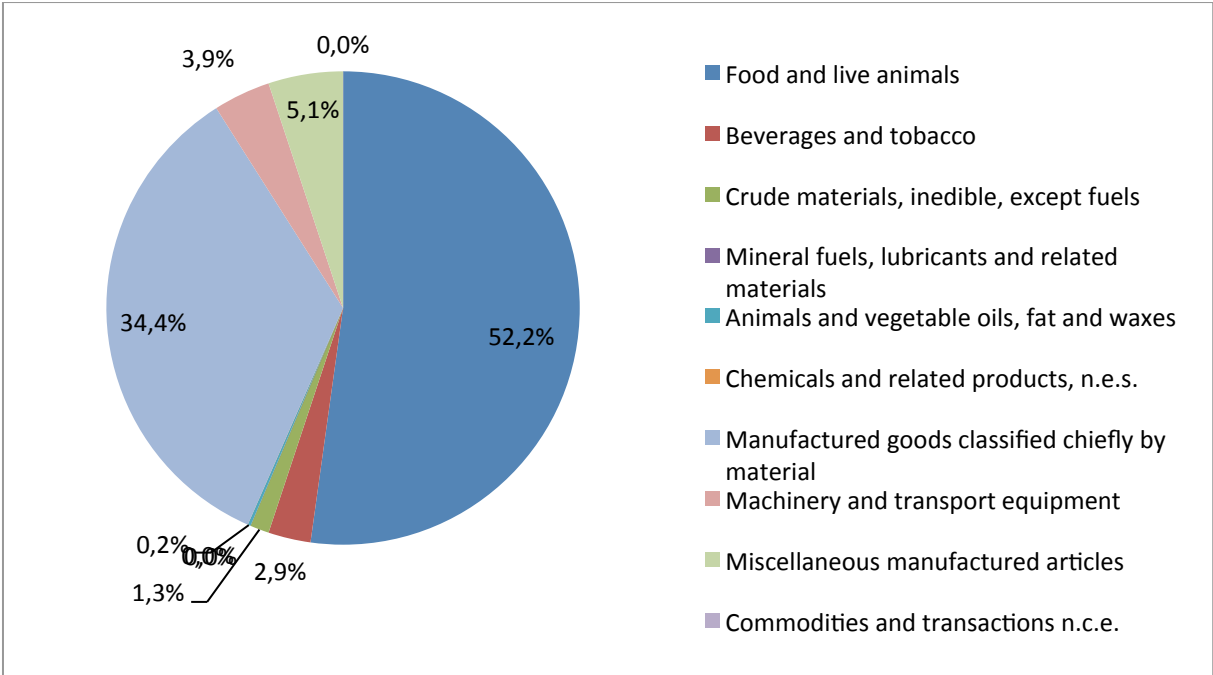


Figure 3: Estonia's imports from China by SITC section, 1993 (Source: Statistics Estonia, 2013)



Although still dominated by machinery and transport equipment (50.9%), Estonian exports now include mineral fuels (10.5%) and various manufactured articles (combined of 17.3%). In 2012, however, imports are dominated by machinery and transport equipment (65.6%), various manufactured goods (in total 27.1 %) and chemicals (5.2%), which is a dramatic change compared to 1993 as China has become a place of processing and assembly. This new

trade pattern is demand driven as Estonia's imports as a whole are dominated by machinery, fuels and manufactured goods. According to the new trade theory, today's trade is demand driven opposed to being supply driven as it used to be, which can explain the intra-industry trade between countries (Hanink and Cromley, 2005: 511). This is clearly visible in this case, too, as China and Estonia trade machinery and manufactured goods with each other to meet the demands of consumers. The economic transition of both countries over the last twenty years has led to similar-similar trade patterns between them.

Figure 4: Estonia's exports to China by SITC section, 2012 (Source: Statistics Estonia, 2013)

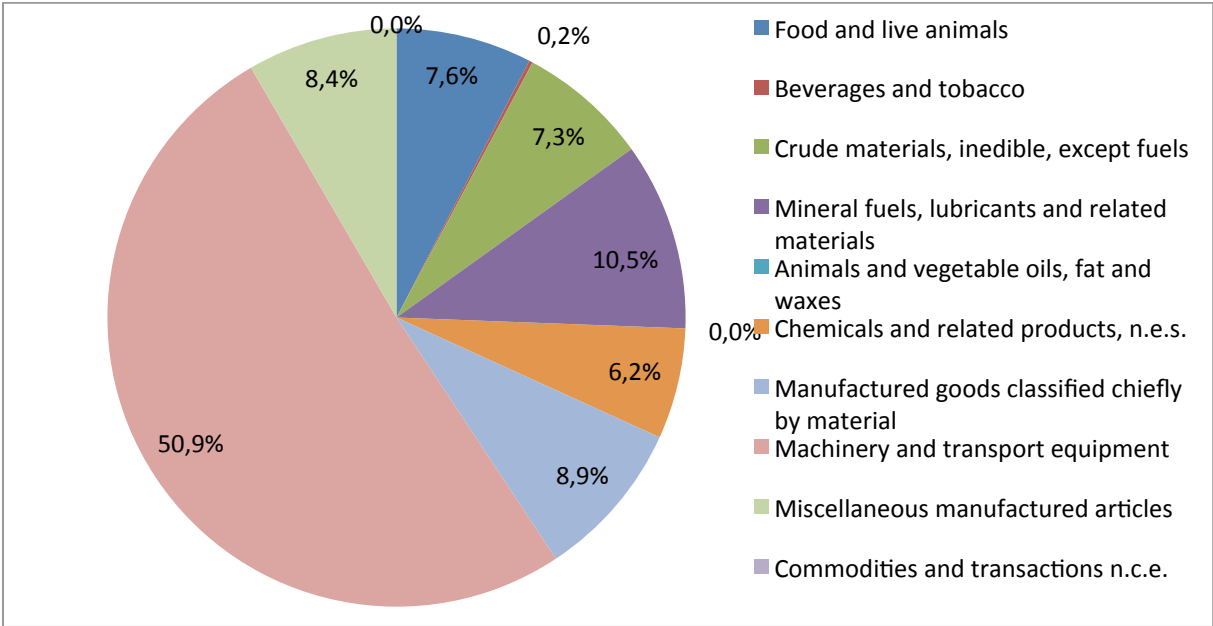
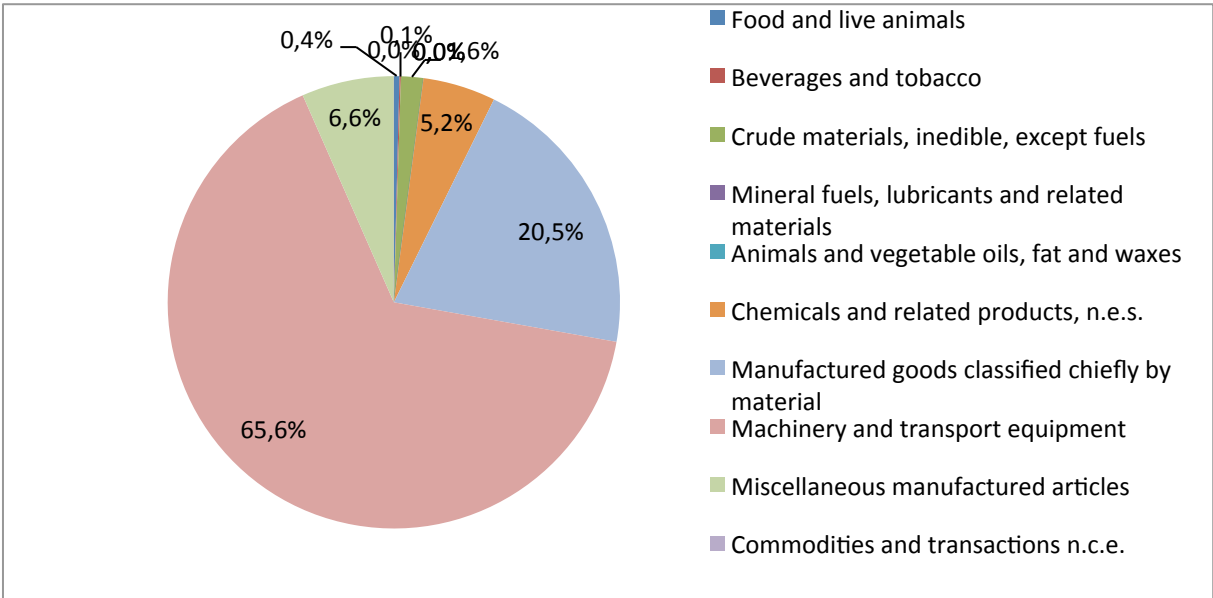


Figure 5: Estonia's imports from China by SITC section, 2012 (Source: Statistics Estonia, 2013)



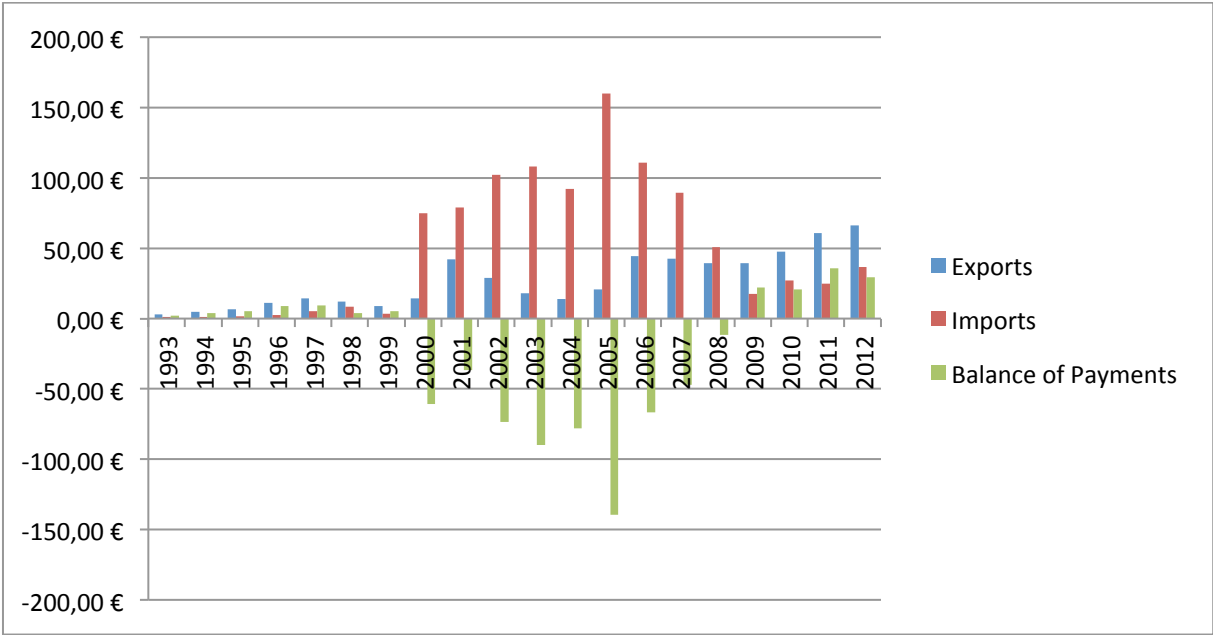
5.3. Trade Relations with Japan

Japan is the second biggest trading partner for the EU in Asia, seventh globally, with the EU being the third biggest trading partner for Japan in turn (European Commission, 2013b), but over the last decade, Japan has been losing its importance as one of the major partners for the EU. The trade relationship between Europe and Japan had traditionally been characterized by strong trade surpluses in favour of Japan, however, these figures have become more balanced recently (European Commission, 2013b). Japan's decline as a main export destination for European goods can be explained by Japan's relatively low economic growth rate over the past ten years, especially when compared to fast growing emerging markets like China (Sunesen et al, 2009: 23). Nevertheless, the strongest economies appear to be the most important trade partners of Japan in the EU (Pasierbiak, 2009: 465).

Compared to the trade relations with China, Japan was a more important partner for Estonia around the time of regaining its independence – trade numbers were definitely higher. However, as Japan is located near several developing countries with low-cost production, moderately low-cost countries that lack this locational advantage are likely to lose out (Deardorff, 2005: 192). For Japan, Estonia at the time was such a distant moderately low-cost country, which meant that Japan could import products similar to Estonian exports from countries much closer. For example, China is a large producer of various goods with comparatively more advantageous location, lowering the transportation costs for Japanese consumers. Thus, one of the reasons behind relatively low trade numbers is simply the geographical location of the countries.

In addition, there has been more trade between Japan, China and neighbouring countries due to historical reasons. Just like history plays a role in Estonian trade relations, it also matters to Japan and China who have been in contact with each other far longer than with any European countries and have therefore established stronger economic ties over time.

Figure 6: Estonia's trade with Japan, million € (Source: Statistics Estonia, 2013)



Whereas Estonia’s trade with China is characterized by increasing imports and low level of exports, with few exceptional years, trade with Japan has been altering more. From 1993 to 2000, Estonia ran a slight trade surplus with Japan, which reached its peak in 1997 and started to decrease after that, rapidly reaching a big deficit in 2000. Surprisingly, one of the most important export articles to Japan was perishable milk and dairy products in general, though in small quantities (Statistics Estonia, 2013). Estonia was still undergoing a structural change of its industries which is why in the beginning of 1990s agricultural products were still one of the most important exports articles – a legacy from Soviet times. At the same time, a lot of goods similar to main Japanese export articles were imported to Estonia from South Korea and Taiwan at that time, because of the lower price of their products which were more affordable for Estonians. The lower living standard of Estonia is yet another reason for the low level of imports because Estonians simply could not afford products with higher quality and prices from Japan at the time.

The second half of the 1990s was the time of economic prosperity in the world, as the world’s real GDP grew and international trade developed (Pasierbiak, 2009: 464) in general. In the period of 2001-2004, trade deficit continued to increase, as imports rose and exports shrank to a rather low level. One explanation for the decrease of exports with Japan is the accession of China to the WTO as trading with China became less restricted for all other member states. Eaton and Kortum (2002) show that as production moves to larger countries (like China)

where the inputs are cheaper, manufacturing in smaller countries (like Estonia) shrinks, resulting in them losing their share in a foreign market. This seems to be the case with Estonian manufacturing as labour force had started to get more expensive and production was moved out to cheaper locations.

Another feasible reason is that the Japanese market is still quite protected. The Japanese government has always allegedly taken advantage of the openness of foreign markets while reserving local markets for domestic firms (Lawrence and Krugman, 1987: 517). Although the tariffs imposed to imports by the Japanese government are generally low, the persistence of non-tariff barriers to trade and investment in Japan (Berkofsky, 2012: 274) are remarkably influencing the trade with Japan.

From 2006 onwards, imports started to decrease and even though they have made a small increase in recent years, they remain rather low. At the same time, exports to Japan have been increasing steadily, and from 2009 onwards, trade has been in a surplus in favour of Estonia again. The same year, Estonian alcohol producer Liviko started to export its products to Japanese market (Liviko, 2009). The alcohol export to Japan has grown fivefold by 2012 (Statistics Estonia, 2013), which is one reason behind Estonia's increasing exports. Another important sector is wood and wood products which has constituted around half of Estonia's exports since 2005 (Statistics Estonia, 2013). During the economic crisis in 2009, imports from Japan did decrease; however, exports to Japan have maintained a steady level which shows that Estonian major export articles have found a stable market.

These changes in the second half of 2000s can be attributed to Estonia's increasing imports from the EU, as Estonia has become fully integrated to the European common market. Also, because of the free trade within the EU and lower transport costs, it is easier and cheaper for Estonia to import goods that are similar to Japanese products from other producers in Europe, rather than from distant Japan. Once again, location matters in trade relations.

5.3.1. Structure of trade

The EU exports to Japan mainly include machinery and transport equipment (34.8%), chemicals and related products (26.1%), and miscellaneous manufactured articles (16.7%). The EU imports from Japan are greatly dominated by machinery and transport equipment

(64.6%), followed by miscellaneous manufactured articles (12.5%), chemical products (10.2%), and manufactured goods (8.3%) (Eurostat, 2013). Import of products from other categories constitutes just a marginal share.

Estonia’s trade patterns with Japan are – similarly to the one of the EU – very concentrated in a few sectors. Exports from Estonia to Japan back in 1993 were overwhelmingly dominated by chemicals and related products (79%), followed by food and live animals (18%). At the same time, export of products from other categories was either non-existent or very small. Almost three quarters of imports from Japan in 1993 were machinery and transport equipment (74.5%), miscellaneous manufactured articles comprised 18.6%, and chemical products 4.6%. Just like with exports, other categories were represented by a minor share or not at all.

Figure 7: Estonia’s exports to Japan by SITC section, 1993 (Source: Statistics Estonia, 2013)

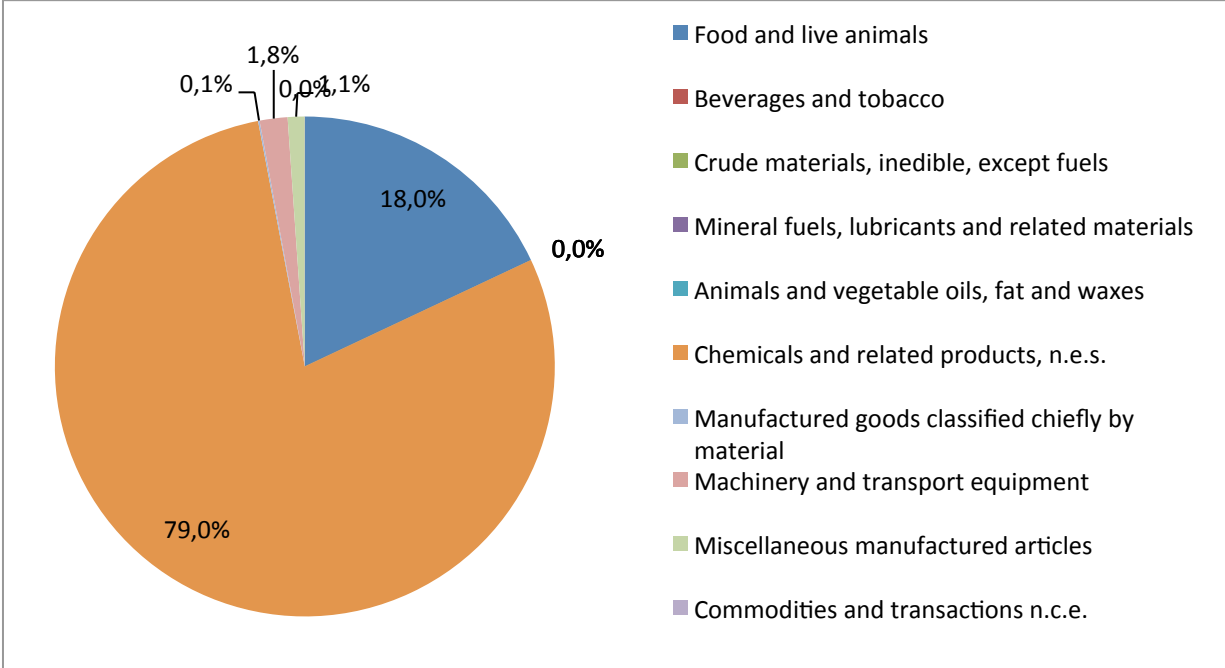
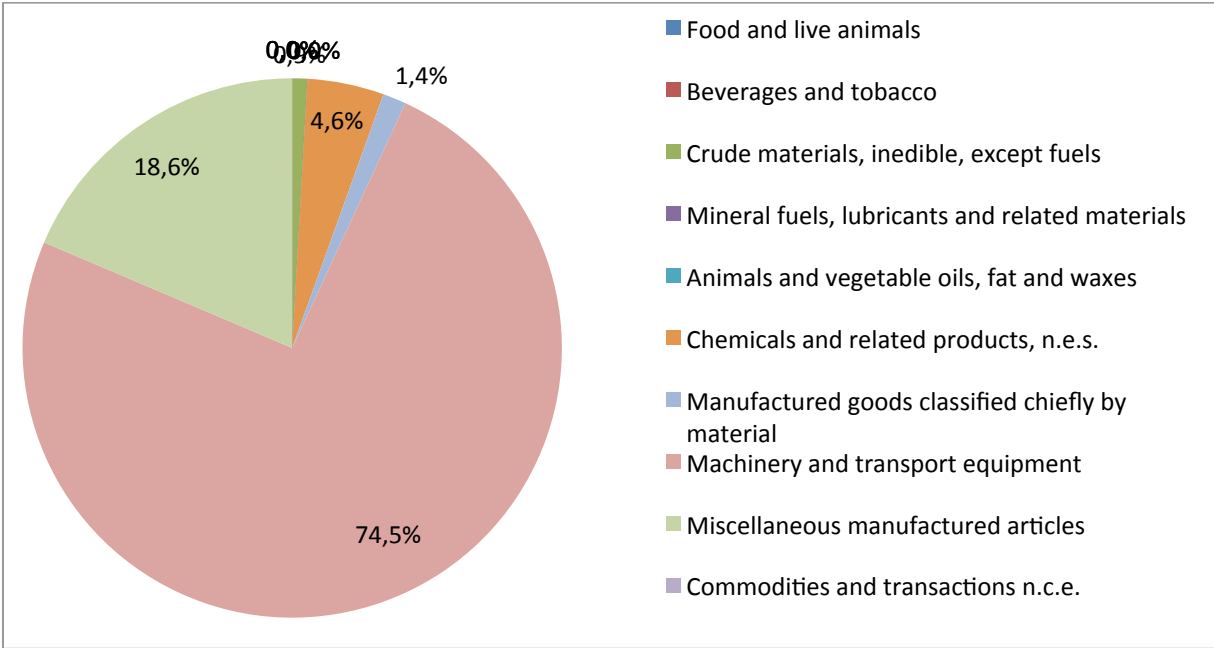


Figure 8: Estonia’s imports from Japan by SITC section, 1993 (Source: Statistics Estonia, 2013)



Similarly to trading with China, Estonia’s trade with Japan was based on comparative advantage. As Japan was a more advanced country, exports from Estonia were rather basic products in exchange for more sophisticated goods. Because of the Soviet legacy, Estonia was still efficient in producing and exporting chemicals and agricultural products before restructuring the economy. At the same time, Japan was more effective in producing vehicles and electronics, much owing to technological advantage.

Export picture looks very different nowadays – more than half of Estonia’s exports are crude materials (52%), mostly timber and wood products. Chemical product export constitutes now 21.7%, and miscellaneous manufactured articles are third most important category with 14.4%. Whereas the composition of exports had changed over the past twenty years, imports are still very much dominated by machinery and transport equipment – namely 82.3% of all imports from Japan. Import of miscellaneous manufactured goods has dropped to 6.9%, but the import of chemical products has made a small rise, now making up 5.9% of all imports from Japan.

Figure 9: Estonia’s exports to Japan by SITC section, 2012 (Source: Statistics Estonia, 2013)

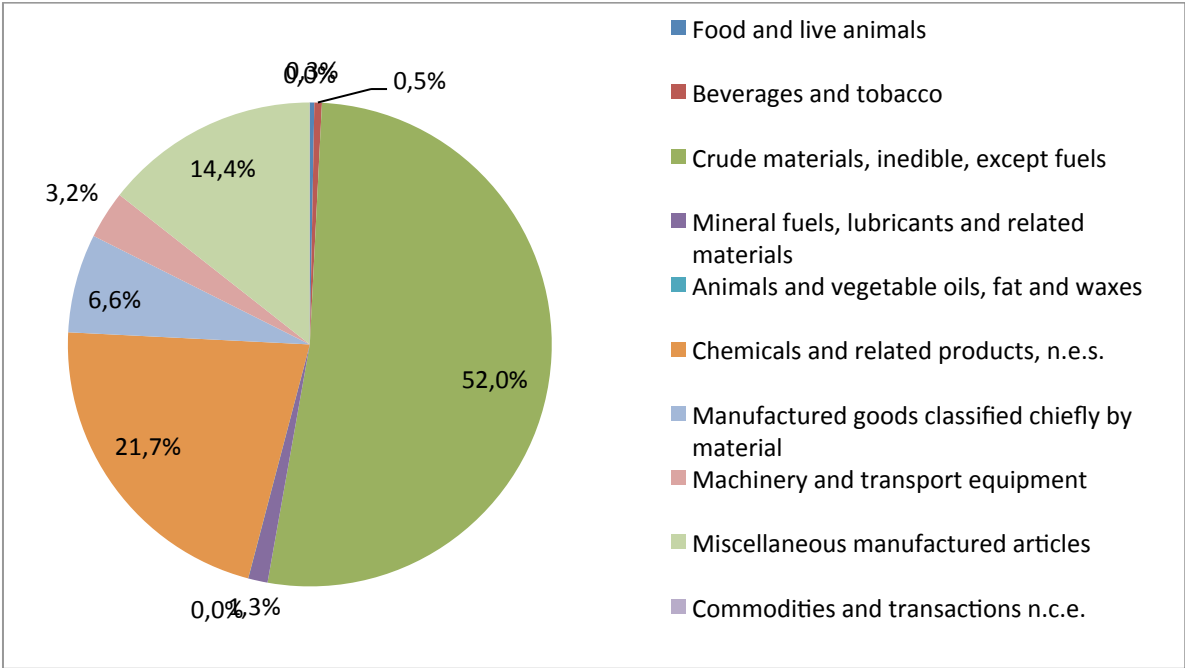
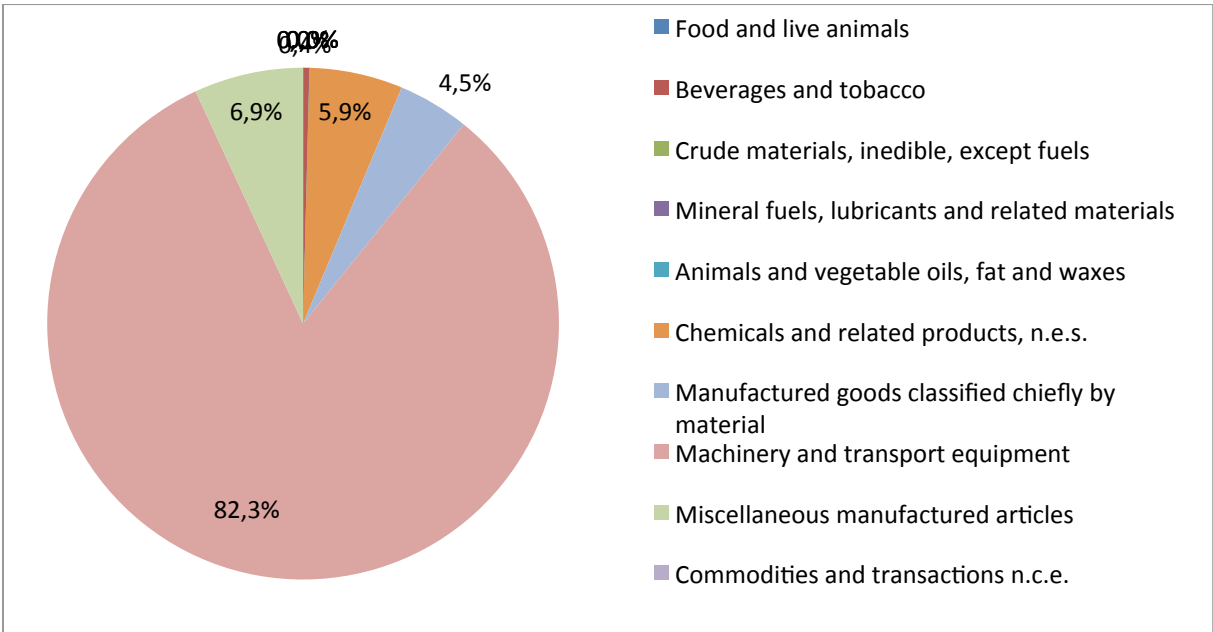


Figure 10: Estonia’s imports from Japan by SITC section, 2012 (Source: Statistics Estonia, 2013)



Even though product categories traded now are quite different from 1993, trade between Japan and Estonia is still based on comparative advantage. Changes in country’s comparative advantage will lead to alterations in its diversification possibilities and, therefore, on its export diversification level (Minondo, 2011: 509). Estonia has re-evaluated its strengths (rich in land) and weaknesses (very small, although highly educated labour force), and consequently

changed the structure of its production, which is why the comparative advantage nowadays is different from the one in 1993. However, the import structure from Japan has remained unchanged because Japanese comparative advantage is still the same – machinery, especially vehicles, and manufacturing, namely electronics.

6. Conclusion

Estonia went through a major economic transformation during the 1990s. It started out as a former Soviet republic with production serving the needs of the Soviet Union instead of its own. Nevertheless, after the collapse of the Soviet Union, Estonia went through rapid changes and restructured its economy. As a small country, Estonia decided to adopt a very liberal foreign trade policy to gain as much as possible from international trade. It became an advocate for free trade and lifted all trade restrictions. However, because of the accession to the European Union, Estonia had to follow the common trade policy and impose restrictions – tariffs, import quotas – to trade with third countries, which was the complete opposite of the foreign trade policy followed until then and brought an end to the era of unilateral trade liberalization.

Even though the EU is generally in favour of freer trade, it keeps some sectors protected due to internal pressure from its domestic producers. Nevertheless, the EU (and Estonia through its framework) is negotiating several free trade agreements to enhance international trade. An FTA with Japan is currently being negotiated which would increase trade between Japan and the EU, including Estonia. There is no immediate plan to start negotiations about an FTA with China though, largely because of the political reasons.

Estonia's trade patterns with two major Asian countries – China and Japan – are very similar to the ones of the EU. There is a lot of intra-industry trade, reflecting the similar-similar phenomena characteristic to trade between more advanced countries. Major change in trade flows took place around the turn of the century. Trade with China took off after 2001, when both China and Estonia had become members of the World Trade Organization and China had taken steps to liberalize its trade. At the same time, Estonian exports to Japan decreased for the same reason, as it became cheaper for Japan to trade with China.

In 1993, trade between Estonia and China was based on comparative advantage, where China exported mostly wheat and livestock, and Estonia exported machinery. However, as both countries underwent major economic transformations and moved up the value chain, trade composition also changed. It is now very much based on intra-industry trade where both countries/partners trade similar articles with each other to meet the demands of their consumers.

Trade between Japan and Estonia was and still is based on comparative advantage although goods exported to Japan have changed. Due to the restructuring economy, Estonia's comparative advantage shifted from chemicals to wood products, whereas Japanese comparative advantage lies where it used to be – mostly in vehicles and electronics.

Based on current patterns and changes in the world economy, it is likely that as China keeps growing economically, imports from China increase even further. Trade with Japan might get a boost once the free trade agreement between Japan and the EU is signed and enters into force.

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