5-22-2017

"New Goods" Trade in the Baltics

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FREE POLICY
NETWORK BRIEF SERIES

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May 2017

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We analyze the role of the new goods margin—those goods that initially account for very small volumes of trade—in the Baltic states' trade growth during the 1995-2008 period. We find that, on average, the basket of goods that in 1995 accounted for 10% of total Baltic exports and imports to their main trade partners, represented nearly 50% and 25% of total exports and imports in 2008, respectively. Moreover, we find that the share of Baltic new-goods exports outpaced that of other transition economies of Central and Eastern Europe. As the International Trade literature has recently shown, these increases in newly-traded goods could in turn have significant implications in terms of welfare and productivity gains within the Baltic economies.

New EU members, new trade opportunities

The Eastern enlargements of the European Union (EU) that have taken place since 2004 included the liberalization of trade as one of their main pillars and consequently provided new opportunities for the expansion of trade among the new and old members. Growth in trade following trade liberalization episodes such as the ones contemplated in the recent EU expansions could occur because of two reasons. First, because countries export and import more of the goods that they had already been trading. Alternatively, trade liberalization could promote the exchange of goods that had previously not been traded. The latter alternative is usually referred to as increases in the *extensive margin* of trade, or the *new goods margin*.

The new goods margin has been receiving a considerable amount of attention in the International Trade literature. For example, Broda and Weinstein (2006) estimate the value to American consumers derived from the growth in the variety of import products between 1972 and 2001 to be as large as 2.6% of GDP, while Chen and Hong (2012) find a figure of 4.9% of GDP for the Chinese case between 1997 and 2008. Similarly, Feenstra and Kee (2008) find that, in a sample of 44 countries, the total increase in export variety is associated with an average 3.3% productivity gain per year for exporters over the 1980–2000 period. This suggests that the new goods margin has significant implications in terms of both welfare and productivity.

In a forthcoming article (Cho and Díaz, in press) we study the patterns of the new goods margin for the three Baltic states: Estonia, Latvia and Lithuania. We investigate whether the period of rapid trade expansion experienced by these countries after gaining independence in 1991—average exports grew by more than 700% between 1995 and 2008 in nominal terms, and average imports by more than 800%—also coincided with increases in newly-traded goods by quantifying the relative importance of the new goods margin between 1995 and 2008. This policy brief summarizes our results.

Why focus on the Baltics?

The Baltic economies present an interesting case for a series of reasons. First, along a number of dimensions, the Baltic countries stood out as leaders among the formerly centrally-planned economies in implementing market- and trade-liberalization reforms. Indeed, those are the kind of structural changes that Kehoe and Ruhl (2013) identify as the main drivers of extensive margin increases. Second, unlike other transition economies, as part of the Soviet Union the Baltics lacked any degree of autonomy. Thus, upon independence, they faced a vast array of challenges, among them the difficult task of establishing trade relationships with the rest of the world, which prior to 1991 were determined solely from Moscow. Lastly, as former Soviet republics, the Baltic states had sizable portions of ethnic Russian-speaking population, most of which remained in the Baltics even after their independence. At least in principle, this gave the Baltic economies a unique potential to better tap into the Russian market.

Defining "new goods"

We use bilateral merchandise trade data for Estonia, Latvia and Lithuania starting in 1995 and ending in 2008, the year before the Global Financial Crisis (GFC). The data are taken from the World Bank's World Integrated Trade Solution database. The trade data are disaggregated at the 5-digit level of the SITC Revision 2 code, which implies that our analysis deals with 1,836 different goods.

To construct a measure of the new goods margin, we follow the methodology laid out in Kehoe and Ruhl (2013). First, for each good we compute the average export and import value during the first three years in the sample (in our case, 1995 to

1997), to avoid any distortions that could arise from our choice of the initial year. Next, goods are sorted in ascending order according to the three-year average. Finally, the cumulative value of the ranked goods is grouped into 10 brackets, each containing 10% of total trade. The basket of goods in the bottom decile is labeled as the "new" goods or "least-traded" goods, since it contains goods that initially recorded zero trade, as well as goods that were traded in positive—but low—volumes. We then trace the evolution of the trade value of the goods in the bottom decile, which represents the growth of trade in least-traded goods.

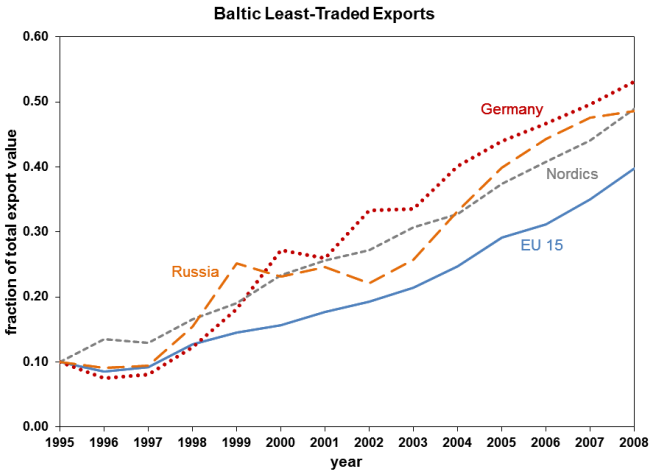
Findings

For ease of exposition, we present the results for the average Baltic exports and imports of least-traded goods, rather than the trade flows for each country. Results for each individual country can be found in Cho and Díaz (in press). We report the least-traded exports and imports to and from the Baltics' main trade partners: the EU15, composed of the 15-country bloc that constituted the EU prior to the 2004 expansion; Germany, which within the EU15 stands out as the main trade partner of Latvia and Lithuania; the "Nordics", a group that combines Finland and Sweden, Estonia's largest trade partners; and Russia, because of its historical ties with the Baltic states and its relative importance in their total trade.

Least-traded exports

Figure 1 shows the evolution over time of the share in total exports of the goods that were initially labeled as "new goods", i.e., those products that accounted for 10% of total trade in 1995. We find that the Baltic states were able to increase their least-traded exports significantly, and by 2008 such exports accounted for nearly 40% of total exports to the EU15, and close to 53%, 49% and 49% of total exports to Germany, the Nordic countries, and Russia, respectively. Moreover, we find that the fastest growth in least-traded exports to the EU15 and its individual members coincided with the periods when the Association Agreements and accession to the EU took place. Finally, we discover that the rapid increase in least-traded exports to the EU15 during the late 1990s and early 2000s is accompanied by a stagnation of least-traded exports to Russia. This suggest that, as the Baltics received preferential treatment from the EU, they expanded their export variety mix in that market at the expense of the Russian. Growth in least-traded exports to Russia only resumed in the mid 2000s, when the Baltics became EU members and were granted the same preferential treatment in the Russian market that the other EU members enjoyed.

Figure 1. Baltic least-traded exports



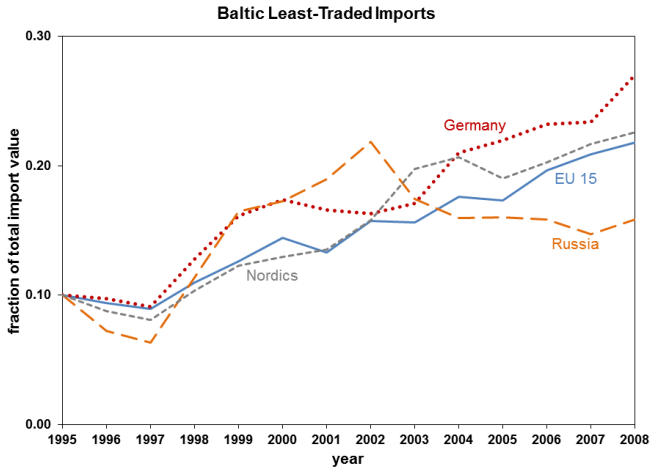
Source: Cho and Díaz (in press).

Least-traded imports

Figure 2 plots the evolution of Baltic least-traded imports between 1995 and 2008. We find that new goods imports also grew at robust rates, but their growth is about half the magnitude of the growth in the least-traded exports—the least-traded imports nearly doubled their share, whereas the least-traded exports quadrupled it. The least-traded imports from the EU15 and its individual members exhibited consistent growth throughout. On the other hand, imports of new goods from Russia—which had also been growing since 1995—started a continuous decline starting in 2003. This change in patterns can be attributed to

the Baltics joining the EU customs union. Prior to their EU accession, the average Baltic tariff was in general low. Upon EU accession, the Baltics adopted the EU's Commercial Common Policy, which removed trade restrictions for EU goods flowing into the Baltics, but—from the perspective of the Baltic countries—raised tariffs on non-EU imports, in turn discouraging the imports of Russian new goods.

Figure 2. Baltic least-traded imports



Source: Cho and Díaz (in press).

Are the Baltics different?

Figure 1 shows that the Baltic states were able to increase their least-traded exports by a significant margin. A natural question follows: Is this a feature that is unique of the Baltic economies, or is it instead a generalized trend among the transition countries?

Table 1: Growth of the share of least-traded exports (percent, annual average)

	1995-2004		2004-2008	
	Baltics	Non-Baltics	Baltics	Non-Baltics
World	8.3	3.9	9.2	0.6
EU 15	10.6	9.2	12.9	0.4
Germany	16.7	6.9	7.5	3.9
Nordics	14.1	11.4	11.6	16.4
Russia	14.2	12.9	10.6	4.9

Source: Cho and Díaz (in press).

Table 1 reveals that the new goods margin played a much larger role for the Baltic states than for other transition economies such as the Czech Republic, Hungary and Poland (which we label as "Non-Baltics"), for all the export destinations we consider. Moreover, we find that while until 2004—the year of the EU accession—both Baltic and Non-Baltic countries displayed high and comparable growth rates of least-traded exports, this trend changed after 2004. Indeed, while there is no noticeable slowdown in the Baltic growth rate, after 2004 the Non-Baltic growth of least-traded exports to the world and to the EU15 all but stops, with the only exception being the Nordic destinations.

Conclusion

The Baltic states, and in particular Estonia, are usually portrayed as exemplary models of trade liberalization among the transition economies. Our results indicate that the Baltics substantially increased both their imports and exports of least-traded goods between 1995 and 2008. Since increases in the import variety mix have been shown to entail non-negligible welfare effects, we expect large welfare gains for the Baltic consumers experienced due to the increases in the imports of previously least-traded goods. Moreover, the literature has documented that increases in export variety are associated with increases in labor productivity. Our findings reveal that the Baltics' increases in their exports of least-traded goods were even larger than their imports of new goods, thus underscoring the importance of the new goods margin because of their contribution to labor productivity gains.

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