

Economic Theory and Policy
Majandusteooria ja -poliitika

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Lectures and Seminars:

Academic year 2001-2002

Fall and spring terms

Tuesdays, 5 pm (if not announced otherwise)

Languages:

English and Estonian

Introduction

“Economic Theory and Policy” is a course in international political economy and investigates the relationship between theory and practical policy of international economic relations. Today’s world is far from having achieved truly open and competitive markets as indicated in some of the economic theories. Political and institutional factors – in addition to the economic ones -- have had a great influence on the outcomes of economic affairs. The interaction between politics and economics on the one hand and the role of ideas, interests and institutions in the state of world economic affairs on the other will be the underlying theme of the course.

This course will be one of the examined electives offered in the Bachelors of Business Administration and Public Administration and Executive MBA programs. The lectures and seminars will cover the main approaches of political economy theories, their relations with different concepts of freedom, and practical implications of the theories. The aim is to provide students with a solid understanding of contemporary theories on monetary policy and trade policy, and the private and public sector agents who influence international economic affairs.

After providing insights into the main schools of thought and their historical evolution, the course focuses on the recent theoretical developments, especially the ideas from laureates of Nobel Prizes in economics and the relevance of their theories to political economy. Special attention will be given to Public Choice, Institutional Economics, the Monetarist school, and Free Trade theories. The last part will focus on the political framework of trade and monetary relations. Developments of General Agreement on

Tariffs and Trade and World Trade Organizations (GATT/WTO), European Union (EU) and regional trade agreements, International Monetary Fund (IMF) and World Bank (WB) will be studied.

To add practical value to the course, the course coordinator will organize guest lectures from prominent academic institutions and from national ministries, multinational and regional organizations. In this sense, Estonia serves as a particularly good location: in the 1990s Estonia established a unilateral free trade regime with no tariffs and, in 1992, pioneered in setting up the currency board in its monetary policy. Thus theoretical concepts of free trade and currency board can be illustrated by the “real-life” presentations of local practitioners.

Brief Course Description and Core Syllabus:

There are two main themes in the course; these will be covered by the lectures and elaborated on in the seminars:

1. What are the contending political and economic arguments in the free markets versus state intervention debate?
2. How do politics and economics interact in the formulation and implementation of economic policy?

The course is divided into three sections:

1. Section One is devoted to the economic and political theorizing on free markets and state intervention. An intellectual-historical overview of the debate between free markets and state intervention is followed by the economics of free markets, the economics of state intervention and, lastly, politics-based approaches to the subject.
2. Section two deals with the contemporary economic theories and their relevance to the political economy. Special focus will be placed on the theories that have received recognition in forms of Nobel Prizes in Economics.
3. Section three looks at the key actors (states, NGOs, companies, WTO, EU, IMF, WB) in international economic policy. Many contemporary issues, such as globalization, digital divide, world poverty, economic development, new protectionism, monetary crisis will receive great attention.

The emphasis of the course is not on the technical aspects of economic theory and policy, nor on applied economics of economic policy; rather it is on the political and institutional context in which economic policy operates. However, students will find it necessary to be acquainted with basic economic concepts in the international economic theory. Students should consult a basic text in international economics. Krugman and Obstfeld's International Economics is of particular help to students with a limited background in international economics.

Aims and Objectives

The course has three basic aims:

1. To familiarize students with basic facts concerning international economic theory and policy and to identify underlying trends that have developed recently;
2. To introduce the variety of perspectives that can be adopted to analyze international economic policy and the variety of actors involved in markets and economic policy formulation;
3. To look in some detail at the role and responsibility of the multinational organizations and their achievements and failures.

The objectives of the course are to promote a critical and informed understanding of the opinions and literature of international economic theory and policy, and to enable students to articulate their understanding of the subject clearly and concisely in both seminar discussions and written essays.

Teaching Method

There will be eight seminars and 27 lectures, with each session having a duration of 1,5 hours. One-half of the lectures -- approximately 14 -- are expected to be presented by guest lecturers. Guest lecturers will weigh heavily especially in topics covered in Sections Two and Three. Eight student-led seminars will provide opportunities for students to present papers on the topics covered in previous lectures. For example, the seminar after the intellectual history lectures will give more detailed understanding about the topics that were not addressed or only slightly reviewed in the previous three lectures. Each student is expected to give several presentations in seminars (the number of presentations depends on the size of seminar group). Seminar presentations will count for up to 20 per cent of the final grade. Students should provide a one-page summary of the main points of this presentation to other seminar members (handout). Presentations must last 15-20 minutes.

Students are also expected to engage in independent study, using the reading list and following the advice of teachers. Students should complete at least three books given in the reading list during the course of academic year.

Students will also be expected to write two essays, each of which will count for up to 15 per cent of the final grade. Each essay must be of a minimum 600 words and of a maximum 1000 word in length. Please do not exceed the word limit: it is part of the learning exercise that you demonstrate you are able to provide a clear and concise answer within it. Essay topics should generally be chosen from seminar questions (see attached), and should be on different topics to those covered in presentations in class. The purpose of the essay is to provide experience of summarizing succinctly and engaging with the literature relevant to a particular question. Essay also assists in the preparation for the course examination. This should be handed in to course coordinator or left to the secretary at EBS office: first essay is due: December 2, 2001 and second essay is due: May 6, 2002

In addition, students will have to take a 'mid-term' exam in January 2002 and a final exam in June 2002. The mid-term exam will account for up to 20 per cent of the final grade, and the final exam will provide up to 30 per cent of final grade.

Course assessment

Participation in seminars will count up to 20 per cent of the final grade. Each essay will count up to 15 per cent of final grade. The mid-term exam will account for up to 20 per cent of the final grade, and the final exam will provide up to 30 per cent of final grade.

Seminars	20 %
Essay 1	15 %
Essay 2	15 %
Mid-exam	20 %
Final exam	30 %

Grading

A+	100-97 %
A	96-93 %
A-	92-89 %
B+	88-85 %
B	84-81 %
B-	80-77 %
C+	76-73 %
C	72-69 %
C-	68-65 %
D+	64-61 %
D	60-57 %
D-	56-53 %
F	52-.... %

Special conditions and penalties

1. Participation in seminars is compulsory. Each student must give presentations (the exact number of presentations depends on the size of seminar group). On the first lecture each student will be assigned seminars and questions. Failure to give a presentation in the assigned seminar will cost student 5 points of final result of maximum 100 points. If for some reason student wants to give a presentation on different day, then she/he is responsible for finding a substitute for the originally assigned day and the possibility to give her/his presentation on some other day.

2. The essays must be turned in by dates indicated above. Failure to turn in the essay on the right time will cost student one point (of 20 possible points) for each day the essay is late.

3. Students who have not taken mid-term exam are not allowed to take final exam. In order to get a final grade and pass the course, the student must receive at least 15 points for her/his final exam.

Assessment criteria for exams and essay

Assessment involves evaluating three categories: presentation, content and critical judgment. The more successful a piece is in each of these categories, the higher score will be received. However, the assessment of written work is an art, not an exact science.

Presentation:

Clarity of expression
Consistency of purpose
Explicit structure
Clear conclusion

Content

Relevance to topic
Development of argument
Demonstration of required reading

Critical judgment

Thoroughness of analysis
Independence of judgment
Critical appraisal

Percentage of possible points Descriptive Equivalent for Exam and for Essay

100-89	The below+original ideas and/or argument
88-77	The below+ A good knowledge of theories and required literature
76-65	The below+ Understanding of key concepts and literature Evidence to back up argument.
64-53	Basic knowledge of lectures. Some factual errors allowed.
52 and below	Anything less than above.

(E.g. 90 percent of 20 possible points for mid-exam is 18)

Reading List

Core Texts

Bhagwati, Jagdish (1988), Protectionism, MIT Press.
Eichengreen, Barry (1996), Globalizing Capital, Princeton University Press.
Irwin, Douglas, A (1996), Against the Tide, Princeton University Press.
Krugman, Paul & Obstfeldt, Maurice (2000), International Economics: Theory and Policy, Addison-Wesley.
Krugman, Paul (1998), Pop Internationalism, MIT Press.
North, Douglass (1990), Institutions, Institutional Change and Economic Performance.
Gilpin, Robert (2001), Global Political Economy, Princeton University Press

Useful Websites

Cato Institute www.cato.org
EU www.eurunion.org
IMF www.imf.org
OECD www.oecd.org
World Bank www.worldbank.org
World Trade Organization www.wto.org

Other Materials

Handouts will be prepared for all lectures and seminars, and relevant articles from academic journals by theorists covered by the course will be distributed; policy-orientated op-eds from leading newspapers will also be handed out at lectures.

Lecture topics

[Lecture 1: material](#)

[Lecture 2: material](#)

SECTION ONE

1. History of free markets versus state intervention
2. Evolution of mercantilism and free trade theories
3. International Gold Standard
4. Economics of free trade
5. Economics of protection
6. Monetary policy in a closed economy
7. Monetary policy in an open economy
8. Politics of state intervention

SECTION TWO

9. International trading system
10. Non-tariff barriers and new protectionism
11. International monetary system
12. Monetarist and Austrian approaches to monetary policy (Friedman, Hayek)
13. Theory of optimum currency area (Mundell)
14. Institutional Economics (North, Coase, Becker)
15. Public Choice (Buchanan, Tullock)
16. Rational Expectations (Lucas)

SECTION THREE

17. Actors in International Economic Affairs
18. WTO
19. IMF and the WORLD BANK
20. The USA and NAFTA
21. EU and EMU
22. Role of multinational enterprises and non-governmental organizations in the international economic system
23. Developing countries
24. Transition economies
25. Estonian trade reform
26. Estonian monetary policy reform
27. Globalization of the world economy

DESCRIPTION OF LECTURE TOPICS AND SEMINAR QUESTIONS

1. History of free markets versus state intervention (Meelis Kitsing)

Lecture: Tuesday, September 11, 5 pm

Arguments in favor of free markets and state intervention in the historical perspective. Broad perspectives from Ancient thinkers to 20th century. Special attention to classical economists, Marx, Keynes and Hayek. Interrelations between the development of different theories and economic reality.

Douglass North, *Institutions, Institutional Change and Economic Performance*, chapters 12 & 13

Douglass North, *Institutions and Economic Growth: A Historical Introduction*

Kevin O'Rourke and Jeffrey Williamson, *When did globalization begin?*, March 2000. (available at: <http://post.economics.harvard.edu/faculty/jwilliam/papers/ehrjgw.pdf>)

Douglas Irwin, *Against the Tide*, chapter 1

Robert Gilpin, *Global Political Economy*, chapter 2 & 3

2. Evolution of mercantilism and free trade theories (Meelis Kitsing)

Lecture: Tuesday, September 18, 5 pm

Development of mercantilist and free trade theories. Focus on non-economic arguments in favor of protection and free trade. Unilateral free trade in UK in 19th century. Protectionism in USA. Rise of protectionism in Europe.

Douglas Irwin, *Against the Tide*, chapters 2-5

Charles Kindleberger, *The Rise of Free Trade in Western Europe*

3. International Gold Standard (Meelis Kitsing)

Lecture: Tuesday, September 25, 5 pm

Development of ideas about gold standard. Functioning of International Gold Standard before 1914 and restoration of gold standard after World War I. Questions of hegemony

and stability. Who benefited and who bore costs. The role of Great Depression and significance of “Keynesian revolution”.

Barry Eichengreen, *Globalizing Capital, chapters 1-3*

Lawrence Broz, *The Domestic Politics of International Monetary Order*

4. SEMINAR (Meelis Kitsing)

Seminar: Tuesday, October 2, 5 pm

Questions:

- 1) What are main non-economic arguments for protection?
- 2) What are main non-economic arguments for free trade?
- 3) Why did UK establish unilateral free trade regime in the 19th century?
- 4) What was the role of UK, France and Germany in the functioning of international gold standard?
- 5) What were the consequences of World War I for international trade and monetary relations in the interwar period?

5. Economics of free trade (Hardo Pajula)

Lecture: Tuesday, October 9, 5 pm

Economic arguments for free trade. Ricardian principle of comparative advantage. Heckscher-Ohlin model. Validity of these models. Who gains and who loses from free trade. The economic consequences of free trade. How these consequences may influence political consequences.

Douglas Irwin, *Against the Tide, chapters 6*

Paul Krugman, *Pop Internationalism, chapter 5& 8*

Paul Krugman & Maurice Obstfeld, *International Economics, chapters 2-7*

6. Economics of protection (Hardo Pajula)

Lecture: Tuesday, October 16, 5 pm

Who gains and who loses from tariff protection? Impact of protection from national and global point of view. What is optimal tariff? Definition of customs union and its impact on third countries. The influence of subsidies or other forms of non-tariff protection compared with tariff protection. Infant industry argument for protection. Strategic trade theory.

Douglas Irwin, *Against the Tide, chapters 12-14*

Paul Krugman, *Pop Internationalism, chapter 1, 3, 4 & 10*

Paul Krugman & Maurice Obstfeld, *International Economics, chapters 8-11*

Cletus C Coughlin, Alec Chrystal & Geoffrey Wood, *Protectionist Trade Policies: A Survey of Theory, Evidence and Rationale*

7. Monetary policy in a closed economy (Kaire Pöder)

Lecture: Tuesday, October 23, 5 pm

The basic instruments of monetary policy, incentives facing monetary policy makers. Keynesians vs. classical interpretations. Rational expectations in monetary policy. Significance of institutional arrangements like central bank independence. Ability of some countries to stabilize inflation more easily than others. IS-LM model.

Paul Krugman & Maurice Obstfeld, *International Economics, chapters 12-17*

8. Monetary policy in an open economy (Kaire Pöder)

Lecture: Tuesday, October 30, 5 pm

Tradeoffs between monetary independence and exchange rate stability. Monetary policy with fixed exchange rate. Monetary policy with floating exchange rates. Distributional effects of exchange rate policy. Tradable vs. non-tradable goods. Credibility issues in an open economy. Currency Board Arrangement—giving up instruments of monetary policy. Mundell-Flemming model.

Paul Krugman & Maurice Obstfeld, *International Economics, chapters 18-20*
Benjamin J. Cohen, *The Triad and the Unholy Trinity: Problems of International Monetary Cooperation*
Jeffrey Frieden, *Exchange Rate Politics*

9. SEMINAR (Kaire Pöder)

Seminar: Tuesday, November 6, 5 pm

Questions:

- 1) Is the Hecksher-Ohlin model of comparative advantage still valid?
- 2) How do the various form of protection (tariffs, subsidies, other non-tariff protection) compare in terms of their impact on the national and global economy?
- 3) What is infant industry argument and under what conditions does it function and what is its impact?
- 4) What is strategic trade theory?
- 5) What incentives influence a government's choice of monetary policy?
- 6) Does central bank independence matter for monetary policy?
- 7) What are the opportunities for monetary policy under Currency Board Arrangement?
- 8) Fixed or flexible exchange rates?

10. Politics of state intervention in international economic affairs (Meelis Kitsing)

Lecture: Tuesday, November 13, 5 pm

Overview of different political economy theories. Structural approaches: hegemonic stability theory, regimes and security considerations. Domestic politics approaches: rational choice and institutionalism. Role of ideas. Democratization and “embedded liberalism”. Conceptions of power in international economic relations: structures, agents and intentions.

Robert Gilpin, *Global Political Economy*, chapter 4

11. International trading system. Non-tariff barriers and new protectionism (Meelis Kitsing)

Lecture: Tuesday, November 20, 5 pm

Institutional structure of the international trading system. The founding of GATT and principles of multilateral trading system. Kennedy Round. Tokyo Round. Reduction in tariffs. Non-tariff barriers and rise of new protectionism.

Robert Gilpin, *Global Political Economy*, chapter 8

Jagdish Bhagwati, *Protectionism*, chapters 1-3

Edward Mansfield and Marc Busch, *The Political Economy of Nontariff Barriers: A Cross National Analysis*

12. International monetary and financial system (Meelis Kitsing)

Lecture: Tuesday, November 27, 5 pm

Institutional developments of international monetary and financial system after the World War II. Establishment of Bretton Woods. The rise of welfare state. The emergence of gold-dollar standard and the role of Cold War. Breakdown of Bretton Woods. The US and tensions within Atlantic alliance. The Role of US and dollar in international finance. Growth of international capital markets. The end of capital controls.

Robert Gilpin, *Global Political Economy*, chapter 9 & 10

Barry Eichengreen, *Globalizing Capital*, chapter 4

John Goodman and Louis Pauly, *The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets*

13. SEMINAR (Meelis Kitsing)

Seminar: Tuesday, December 4, 5 pm

Questions:

- 1) What is the best political economy theory in explaining international trade relations?
- 2) What does serve as the best political economy theory in explaining international monetary and financial relations?
- 3) What does distinguish new protectionism from old protectionism?
- 4) What does explain the breakdown of Bretton Woods international monetary system?
- 5) Why have international capital markets continued to grow so rapidly since the 1970s?

14. Monetarist and Austrian approaches to monetary policy: Friedman and Hayek (guest lecture)

Lecture: Tuesday, December 11, 5 pm (to be confirmed)

Monetarist approach, particular focus on Milton Friedman. Role of money supply in economic management. Austrian approaches to monetary policy. Link with currency board. Return to gold standard and privatization of money. Austrian and monetarist approaches to inflation. Austrian critique of monetarists' interventionism. The relevance of theories to the current international financial system

15. Theory of optimum currency area: Mundell (guest lecture)

Lecture: Tuesday, December 18, 5 pm (to be confirmed)

Economics and politics of optimum currency area, particular attention to Mundell. Relevance of the theory to current currency areas (EMU, US).

16. MID-EXAM

TBA

17. Rational Expectations: Lucas and Sergeant (guest lecture)

Lecture: TBA

Arguments against the Phillips curve relationship. Adaptive expectations and rational expectations. Misconception about rational expectations. Influence of rational expectations on current consensus: no long-term Phillips curve but short-term tradeoff exists. Relevance for international monetary and financial relations.

18. SEMINAR (Hardo Pajula)

Seminar: TBA

Questions:

- 1) Are the Austrian approaches to monetary policy unrealistic in the current situation of international economic system?
- 2) What are the key differences between Austrian and monetarist approach to monetary policy?
- 3) Why has the monetarist approach become so influential during the last decades?
- 4) Is EMU an optimum currency area? Does it matter?
- 5) Do people have “rational expectations” about the monetary policy?

19. Institutional Economics: North, Coase, Becker (guest lecture)

Lecture: TBA

Theories and research areas of rational choice institutionalists (new institutionalism). Transaction costs. Definition of institutions. Role of institutions in economic development. Relevance for international economic affairs.

Douglass North, *Institutions, Institutional Change and Economic Performance*

20. Public Choice: Buchanan and Tullock (guest lecture)

Lecture: TBA

Theories of public choice thinkers. Their relevance for international economic affairs. Role of interests, politicians and government officials in trade and monetary policy. Political rent-seeking and political business cycle. Link between domestic politics and international economic policy.

21. SEMINAR (Meelis Kitsing)

Seminar: TBA

Questions:

- 1) How important is the domestic institutional framework for a country in order to be successful in international trade and financial markets?
- 2) Are the problems of developing countries more caused by their weak institutions or their vested interests?
- 3) What are the institutions according to Douglass North?
- 4) How do domestic interests influence international trade?
- 5) What's the role of interests in monetary policy?

22. Actors in International Economic Affairs: An overview (Meelis Kitsing)

Lecture: TBA

The current actors in international trade policy: WTO, EU, US, developing countries, developed countries, transition economies, multinational enterprises. Multilateral trading system. The current actors in international finance and monetary policy: IMF, World Bank, US, EMU, developing countries, developed countries, commercial banks and the Bank for International Settlements.

Philip Cerny, *Globalization and the Changing Logic of Collective Action*
Susan Strange, *States, Firms and Diplomacy*

23. WTO in the International Trading System (guest lecture)

Lecture: TBA

Transformation of GATT into the WTO. Uruguay Round. Development of WTO before and after Seattle ministerial meeting. New issues: regulatory policy, policy harmonization, fair trade, environment, labor standards and competition policy.

Alison Butler, *Environmental Protection and Free Trade: Are They Mutually Exclusive?*

24. Regional trade cooperation: EU and NAFTA (guest lecture)

Lecture: TBA

The major players in international trade and their recent development. Decision making in EU and US. Special interests in trade policy decision-making. Link between regionalization and multilateral trading system. Trade diversion and creation in the case of EU and NAFTA.

Robert Gilpin, *Global Political Economy, chapter 13*
Ronald Cox, *Explaining Business Support for Regional Trade Agreements*

25.SEMINAR (Meelis Kitsing)

Seminar: Tuesday, March 26, 5 pm

Questions:

- 1) Is WTO dealing with too many issues?
- 2) Should the environmental issues be added to WTO agenda?
- 3) Is EU trade diverting or creating in agriculture?

- 4) Does the regional trade cooperation in the case of EU and NAFTA create a barrier for more efficient international trading system under the umbrella of WTO?
- 5) Which actors possess most of the power in the international trading system and how do they use it?

26. IMF and the WORLD BANK (guest lecture)

Lecture: TBA

Assessment of structure, policies and roles of IMF and World Bank since 1970s. The impact of debt crisis and the end of Cold War. Mexican, Asian and Russian crisis. The debate over the role of both institutions in the world economy.

27. EU and EMU (guest lecture)

Lecture: TBA

The historical significance of European monetary integration for the world economy, Europe and wider political context. The creation of EMS. Transformation from EMS to EMU. Role of France, Germany and UK. The current economic and political dimensions of Economic and Monetary Union in Europe. Global consequences of monetary union.

Charles Wyplosz, *EMU: Why and How It Might Happen*

28. Role of multinational enterprises and non-governmental organizations in the international economic system (guest lecture)

Lecture: TBA

The role of commercial banks in international finance and integration of national financial markets. Removal of capital controls and financial deregulation. The role of multinational enterprises in international trade. Rapid growth of FDI. Criticism of the current system by NGOs. Links between businesses and governments from one hand and governments and NGOs on other hand.

Robert Gilpin, *Global Political Economy, chapter 11*

Shah M. Tarzi, *Third World Governments and Multinational Corporations: Dynamics of Host's Bargaining Power*

29. SEMINAR (Meelis Kitsing)

Seminar: TBA

Questions:

- 1) Are IMF and World Bank trying to do too much?

- 2) Is IMF acting in the interests of international commercial banks?
- 3) Is World Bank captured by the NGOs?
- 4) Why has there been a rapid growth in FDI during the last decades?
- 5) Which are more powerful actors in the international economic system, NGOs or MNEs?

30. Developing countries (guest lecture)

Lecture: TBA

The development from import-substitution to export-orientation. The role of developing countries in international trade and investment. The reforms of trade and monetary policy in developing countries. Their relations with US, EU, WTO, IMF and World Bank.

Joseph Stiglitz & Lyn Squire, *International Development: Is It Possible?*

Jeffrey Williamson, *Globalization and Inequality, Past and Present*

Stephan Haggard, *Inflation and Stabilization*

31. Transition economies (guest lecture)

Lecture: TBA

Transformation from state-planned system to market-oriented economy. Trade and monetary policy reforms. Their role in the international economic affairs. Relations with IMF, World Bank, WTO, US and EU.

Razeeen Sally & Magnus Feldmann, *From the Soviet Union to the European Union: Estonian Trade Policy Reform*

32. Estonian trade reform (guest lecture)

Lecture: TBA

Re-orientation of trade in the 1990s. Unilateral trade with other countries. Institutional decision-making. Economics and politics of Estonian trade reform. Accession to WTO. The future within EU.

33. Estonian monetary policy reform (Kaire Põder and guest lecture)

Lecture: TBA

Introduction of *kroon* and currency board in Estonia. Independence of Central Bank. Tradeoffs of monetary policy. Political and economic factors. The current problems and future within EMU.

34. Globalization of the world economy: vision of the future (guest lecture)

Lecture: Tuesday, May 28, 5 pm

Debate over globalization. The level of globalization at the moment and future development. Meaning for international finance and trade.

Dani Rodrik, *Sense and Nonsense in the Globalization Debate*

Robert Gilpin, *Global Political Economy, chapters 14 & 15*

35. CONCLUDING SEMINAR (Meelis Kitsing, Kaire Põder and Hardo Pajula)

Seminar: Tuesday, June 4, 5 pm

Questions:

- 1) Why have some transition economies been more successful than others in their trade and monetary policy reforms?
- 2) Why did Estonia choose to have unilateral free trade in the 1990s? Was it wise decision?
- 3) Has currency board been effective tool for monetary policy in Estonia?
- 4) What are benefits and pitfalls of EU for Estonian trade policy?
- 5) What are benefits and pitfalls of EMU for Estonian monetary policy?