RUSSIAN-ESTONIAN ECONOMIC AND INVESTMENT COOPERATION DURING THE CRISIS: DYNAMICS AND POSSIBILITIES

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The article deals with the development in the Russian-Estonian relations during the crises of 2007 and 2014, taking into consideration the balance between political and economic factors in the decision-making of the Estonian government. A number of special aspects, trends and problems in trade and investment ties are detected.

The aim of the study is to uncover the key motivation behind the actions of both Russia and Estonia, to identify the drivers for economic and political development in the region, and to work out recommendations to adjust them. The questions put forward by the authors of this article could not be more topical at the time, when Russia's economic situation is obviously getting worse and capital flight (to the neighboring EU Member States) is likely to increase.

The method of the study is a comparative analysis of the impact on economic ties made by the Russian-Estonian crisis of 2007 and the current international tension around Ukraine. The regional fossil fuel market and the possibilities of Gazprom involvement in its development are also analyzed.

It is concluded that political motives are still important for Estonia's decision-making, though they are balanced out by measures of business support (despite some of these measures being taken by the EU bodies). The role of political factor for the Russian side is increasing. It is acknowledged that there is a growing number of missed economic opportunities in the Russian Northwest.

Key words: Russia, Estonia, economic cooperation, trade balance, foreign direct investments, sanctions, competition among jurisdictions

The crisis in the relations between Russia and western countries — primarily, the EU member states — has accentuated a number of problems. Ma-

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Submitted on March 14, 2014.

doi: 10.5922/2079-8555-2015-21-4

ny of these problems existed earlier. However, they have become extremely acute only today. One of these ‘controversial issues’ is the balance between political considerations and international business interests[1]. Russian-Estonian relations have always demonstrated this dualism. The current crisis emphasised it and gave it a new twist.

Background

Russia’s relations with the Baltic neighbours have never been easy or predictable demonstrating a lack of pragmatism and balance between political emotions and economic interests. Estonia is Russia’s important economic partner due to objective geographical and infrastructure parameters (one of the few EU members sharing a long common border with the Russian Federation; the country has a seaport which is the closest to the EU and its infrastructure is used to export Russian goods to the EU). However, in political and ideological terms, the country has proved to be an obstacle to a constructive dialogue with western partners. The two parties make regular mutual accusations — Russia accuses Estonia of discrimination against the Russian-speaking population, glorification of fascism, and a lack of respect for the memory of the fallen Soviet soldiers, whereas Estonia accuses Russia of denying occupation, imperial ambitions, and meddling with the country’s domestic affairs, etc.

Nevertheless, the development of economic relations took its natural course: Russia was actively using Estonia’s transit capacities for exporting Russian goods to the EU and taking advantage of the investment opportunities. The economic cooperation was facilitated by both Estonia’s geographical position and long-standing cultural and social ties — approximately 25 % of Estonia’s population speaks Russian. In turn, Estonia sold its products (mostly those of the mechanical engineering and food industries) in the large Russian market, which became especially important after the country’s accession to the EU in 2004, which was associated with a steep increase in market competition and the need to comply with the rules of the EU’s common agricultural policy (fig. 1).

It seems that the lack of a clear and comprehensive strategy for economic cooperation demonstrated by both parties hampered the development of mutually beneficial and trust-based relations. Such relations could overweigh the lack of mutual political understanding in the periods of tension. This article analyses two crises in the Russian-Estonian relations that took place in the recent decade and the reaction they caused from both sides.

[1] For more detail on the correlation between the economic and political factors in making foreign policy decisions, see [17—19].

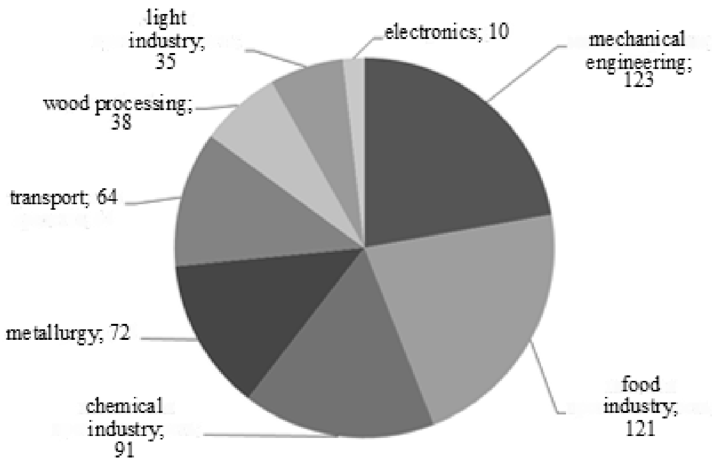

Fig. 1. Structure of Estonian exports to Russia in 2006, million euros

Based on [1].

The 2007 crisis

The 2007 events associated with the relocation of the memorial to Soviet soldiers to Tallinn's outskirts were widely discussed in the Russian mass media. It became a litmus test for many processes taking place in Estonia. Attention was drawn to the correlation between the political and economic factors and the country's policy in the international arena.

The actions taken by the Estonian government significantly damaged the interests of business. The transit industry lost much in cargo — at the time, Estonia handled 25 % of Russia's petroleum product exports to the EU. Other substantial transits included products of the coal, forest, chemical, and metallurgical industries. The irregularities in the Russian railways' operation in Estonia, which followed the memorial relocation, complicated transit from the EU to Russia, which accounted for a significant proportion of the operation of Estonian transport infrastructure (railways, ports, and terminals). According to the national railway company of Estonia, the cargo tonnage decreased in January-March 2008 by 41 % as compared to the similar period of 2007. Oil transportation dropped by 33 % and transit by 45 % [14]. As a result, approximately 10 transit companies stopped their operations and 200 employees were laid off.

In general, the losses sustained by the country's economy reached 8 million krooni (0.5 billion euros) per year, which accounts for approximately 3 % of the country's GDP. Moreover, the one-time losses in the post-crisis period were catastrophic for a number of industries. Experts estimate these losses at 320 million euros without taking into account profit and mid-term losses [20]. Bilateral trade was also affected (fig. 2).

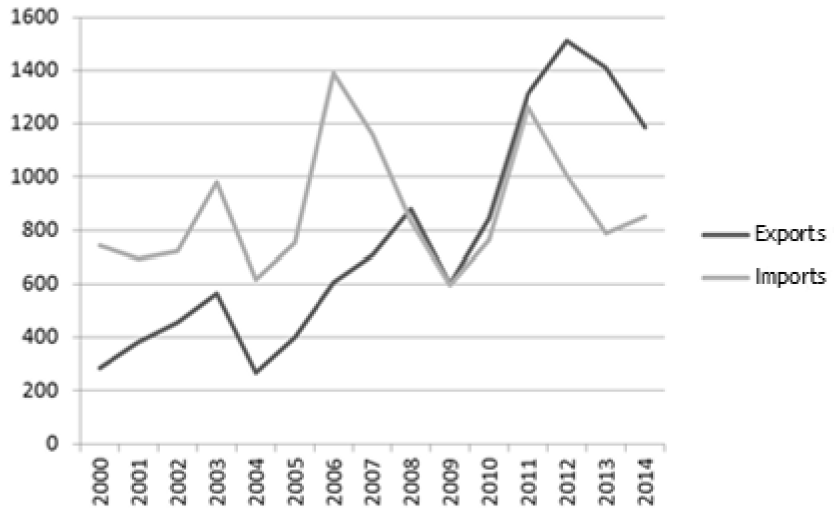

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Fig. 2. Estonian-Russian trade in 2000—2014, million euros

Based on [1].

Russia launched projects aimed to transfer business activities from the Estonian to Russian border areas. The construction of a cutting-edge terminal in the port of Ust-Luga received a boost; a comprehensive programme for the development of Russian ports in the Baltic was adopted in that period.

For Estonia, another sensitive consequence of the political conflict was the mass exodus of Russian companies and investors and their re-orientation to the neighbouring countries and Russian border areas. The first companies to leave the country were transit businesses providing logistics and infrastructure-related services — the Estonian Oil Service AS oil transhipment terminal, which handled around a quarter of the Russian fuel oil export to the EU, was sold by its owner Severstaltrans. The company froze other Estonian projects with the largest being the construction of a car manufacturing facility[2].

Large companies operating in different fields were also guided by the logic of politics: the Akron Chemical Holding abandoned a number of investment plans in Estonia, whereas VTB Kapital sold its stake in a local real estate development company.

Despite the fact that the economic effect of the conflict was much more tangible for Estonia than Russia, Russian companies were also faced with a number of problems relating to the need to reroute transit. The Russian Baltic ports, including Saint Petersburg, were not ready to handle the required tonnage, which resulted in considerable time and reputation losses for businesses.

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[2] At the time, such investments aimed to avoid paying the EU's high import duties for finished goods were very popular among Russian companies striving to penetrate the EU market. A company abandoning such project meant the primacy of politics over economy in operations in this region.

However, the greatest losses were sustained by Estonian businesses. The pressure exerted by business circles on Estonian authorities over the following years cooled the latter down and made them tackle certain political and image-related issues more rationally. This affected both the further interaction between the two countries and Estonia's behaviour during the current Ukraine crisis, which is also politically driven to a great degree.

Cooperation in 2007—2014

The post-crisis period in Russian-Estonian relations was characterised by a sporadic increase in trade and economic cooperation, which was interrupted first by the 2008 world economic crisis and the 2014 Ukraine political conflict. Fluctuations in the bilateral trade and investment reflect these changes.

In terms of exports, Russia is Estonia's third largest trade partner: the country accounts for 12.1 % of total exports; however, in terms of imports, Russia ranks sixth with 6.8 %. The trade structure has not changed significantly over the past 20 years (fig. 3).

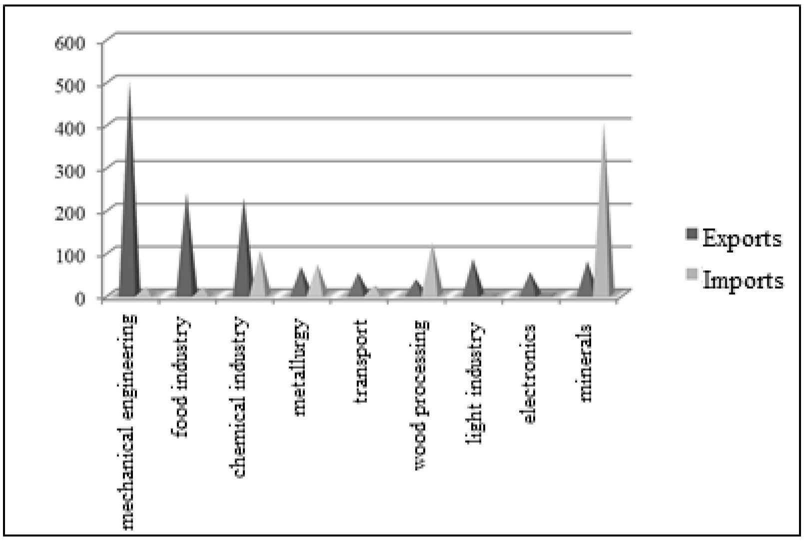

Fig. 3. The structure of Russian-Estonian bilateral trade in 2013, million euros

Based on [1].

Russian-Estonian investment ties developed much slower than in the pre-crisis period: Russian businesses became less active due to political reasons, whereas Estonia was seriously affected by the 2008 crisis. The level of Estonia's investment in Russia, which was rather high in the early and mid-2000s, dramatically decreased. The proportions of bilateral foreign direct investment in the FDI stock remained insignificant (fig. 4 and table 1).

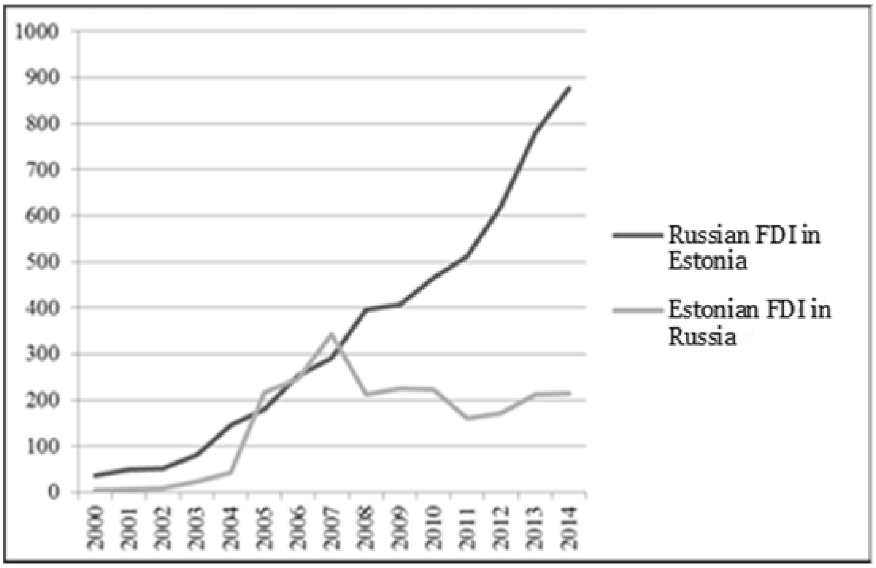

Fig. 4. Bilateral Russian and Estonian FDI in 2000—2014, million euros

Based on [1].

Table 1

Bilateral Estonian and Russian FDI stock in 2003—2014,%

FDI	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Russian in Estonia	1	2	2	3	3	4	4	4	4	4	5	6
Estonian in Russia	3	4	14	9	8	5	5	6	5	4	4	4

Based on [1].

Most cooperation took place ‘beyond politics’ as interactions between small and medium enterprises. The attempts to intensify cooperation were made in the framework of Lake Peipsi Project, the Pskov-Livonia euroregion, and the Narva-Ivangorod twin city project [4].

A serious obstacle to such cooperation is the absence of an agreement on the Russian-Estonian border. The signing was stalled in the 1990s by fundamental differences in the interpretation of the 1918 Treaty of Tartu, which is not recognised by Russia and is referred to in the preamble to the agreement by the Estonian party [8, p. 140].

Shortly before the Ukraine crisis, a new version of the agreement was approved and signed, however, its ratification was stalled due to cooling relations.

The absence of an agreement complicates business activities in the border areas, in particular fishing and navigation within Lake Peipsi, hinders the handling of transit goods, and makes it impossible to modernise border checkpoints — and thus to increase their operational capacity and the cargo traffic. The uncertainty of the border line and the atmosphere of mutual distrust resulted in a number of widely discussed incidents in the border area[3], which strengthened the idea on the either side of the border that the other country is an undesirable and even dangerous location for doing business. Today, the above mentioned cross-border cooperation projects exist mostly on paper. They are constantly faced with organisational complications; the legal framework remains poorly developed and their funding is sporadic [6, p. 50]. The efforts, characterised by relatively sustainable development, are the Lake Peipsi and Narva-Ivangorod projects. However, this has been proven [21, p. 128] to be a result of the support from EU institutions.

The 2014 crisis and sanctions

The new crisis of 2014 was another crucible for the bilateral relations and revealed new components of Estonia's economic policy based on the country's previous experience. The mistakes made by both parties also became evident.

The cooling of political relations first affected investment cooperation. As mentioned above, it experienced difficult times before the crisis. However in 2014, its scope, structure, and dynamics underwent significant changes.

A significant imbalance between investment flows emerged: Estonia's investment stopped with the exception of OU Ecomet Invest [16], whereas Russian investment was steadily increasing.

In the heat of the political conflict, Russian businesses were implementing investment projects, announcing plans to launch production facilities in Estonia (table 2), and contacting the Estonian-Russian Chamber of Businessmen, the Russian Embassy in Estonia, and other relevant bodies asking for information support as to investment opportunities in the country. The key reason behind it was the aspiration to minimise the increasing risks associated with conducting business in Russia against the background of the Ukraine crisis. These risks include the weakening rouble, possible unfavourable changes in the political situation, and the general economic instability.

[3] For instance, the arrest of the Estonian security official Eston Kohver in September 2014 at the Russian-Estonian border by FSB. The questions as to the lawfulness of the arrest and whose territory the Khover was detained on are still open to discussion. Shortly after that, the Estonian police 'responded' with arresting two Russian fishers on the Narva River. The fishers were reportedly identified as former KGB officers. They were released after two months in custody.

Table 2

Russian investment projects in Estonia in 2014

Company	Date	Project	Project stage
STK Group OÜ (owned by A. Pruidze, G. Nabiulin, and P. Starchenko)	November 2014	Oil refinery in the port of Sillamäe, 75 million euros	Waiting for the construction permit, 1.5—2 years
EmLak	April 2014 — January 2015	Paint and varnish manufacture, 3 million euros	A factory has been opened in Narva
Natura Siberica	April 2014	Cosmetics manufacture in Tallinn	A plan was announced to obtain raw materials and manufacture goods in Estonia
IST (A. Nesis)	September 2014	Urea plant in the port of Sillamäe	A plant to construct a plant was announced
Real estate			
Lepidus Ltd (owned by D. Skvortsov)	2014	De la Gardie shopping centre building	Purchased
DLT Capital (T. Tolstaya, V. Yakovlev)	2014	Cinamon cinema chain	Purchased
Star Investments (14 Russian investors)	2014	Warehouse and office buildings of the Magnum Medical company	Purchased

Based on [3; 7; 12; 13].

According to the members of the business community, the advantages of investment in Estonia include the location of infrastructure on the territory of the European Union in close vicinity to the Russian border, often in a special economic zone, the ease of starting and doing business, favourable tax regulations, the opportunity to obtain a residence permit, and others.

Another competitive advantage of Estonia as compared to the Russia's North-West is a programme for attracting eastern investors, which was launched in 2014. Within this programme, any investor can obtain so-called e-residency and a temporary residence permit if they register their company in Estonia. However, as any other businessperson, they will be exempt from the corporate tax reinvested in the country's economy. This initiative followed the abandonment of a similar practice in Latvia, which had given the country a significant number of new residents. Estonia plans to 'pull over' most of potential Russian investors from Latvia thus attracting approximately 10 million e-residents, the country's population being 1.3 million people [15].

These examples show the efforts taken by the Estonian authorities to rectify the mistakes made after the 2007 crisis, which adversely affected local businesses. In the current conflict, the opposition between the political and economic interests is not that pronounced — additional measures have been taken to protect the interests of businesses.

However, the temptation to join the political game did not go unnoticed. This time, ordinary consumers, small businesses, and farmers were affected. This became especially pronounced as the 'war of sanctions' between Russia and Estonia broke out. The Estonian government was one of the most consistent supporters of imposing sanctions against Russia — including economic ones. As a result of the Russian countersanctions, the Estonian economy lost 0.4 % of GDP (75 million euros), whereas the indirect losses are estimated at twice that level by the Estonian Institute of Economic Research [11].

As mentioned above, Estonia has a positive trade balance with Russia. In June 2014, Russia accounted for 24 % of Estonia's dairy, 9 % vegetable, and 5.5 % meat exports. The food import ban made Estonian producers (first of all, those in the dairy industry) look for new markets. For many of them, this turned out to be a grave problem — some firms went out of business or significantly reduced their output. As a result, around 2,000 people were laid off. According to a survey conducted by the Institute of Economic Research, 31 % of companies were affected by sanctions, which led to a decrease in turnover and cost effectiveness [2].

In general, Estonia's food exports to Russia reduced by more than 60 % over six months (August 2014 — February 2015). The trade balance, although still positive, decreased by almost 50 % — from 664 to 334 million euros in 2014 [1].

Estonian politicians have a rather casual attitude to sanctions stressing that sanction-related losses are temporary and insignificant. However, according to an unofficial forecast of the Estonian Ministry of Economy and Infrastructure, the full effect of sanctions will be visible only at the end of 2015 — the transport and transit industries will have been affected by then [9]. It is worth stressing that, at the beginning of 2015, the Estonian company GoRail almost faced insolvency as a result of the weakening rouble and decreasing traffic of goods to Russia, which coincided with the increase in fuel excise in Estonia.

The GoRail situation demonstrates another aspect of the policy of tightening the screws on Russia. A serious long-term consequence of the current crisis is a reduced number of Russian tourists coming to Estonia caused by the weakening rouble. The tourist industry is one of the crucial areas of Estonia's economy: in 2013, it contributed 13.6 % to the country's GDP. Russians account for 16 % of all tourists, this proportion increasing during New Year and May holidays. In Estonia's North-East, approximately 45 % of tourists come from Russia. A reduction in the number of Russian tourists will become a serious test for Estonia's tourist industry in the years to come.

This situation shows that, again, a number of Estonian officials sacrifice the country's economic interests to political ambitions. Probably, during the current crisis, this policy was chosen consciously in hope of attracting support from the EU fund established to help farmers affected by the Russian embargo. However, the 400 million euro fund was not enough to compensate for even a small share of the sustained losses. Moreover, the fund's mechanism could not provide Finnish farmers with support when they needed it most — in the first months after the embargo was imposed.

Energy cooperation

The energy issue is one of the most sensitive in Russian-Estonian relations. The country — as well as Finland, Latvia, Lithuania, and Slovakia — imports 100 % of its gas from Russia. Gas does not account for a significant proportion of Estonia's energy consumption (4—7 % over the past decade according to the Estonian statistics). However, its proportion is not decreasing despite the statements made by some Estonian politicians expressing anti-Russian sentiments[4].

A good example is the incident that took place in the summer of 2014. The Minister of Economy and Infrastructure Urve Palo sent a rather indignant open letter to the head of the Estonian distribution network operator EG Võrguteenus, S. Jefimov, asking for an explanation of how his company would sustain a stable gas supply if Russia stopped exporting gas to Estonia and other Baltic states dependent on Russian gas. It is worth stressing that, by the time, the Ministry of Economy and Infrastructure had already developed an action plan in case of an interruption in the gas supply from Russia. Large energy consumers (in particular, the company providing heating to Tallinn's residential areas) had to operate on fuel oil. The rest of winter gas consumption needs could be met by the Latvian Inčukalns gas storage facility, which supplies not only Latvia, but also Russian border areas and the Kaliningrad region in the winter period. The latter serves as another argument against the alleged intentions of Russia to interrupt the gas supply to the Baltics or resort to 'gas blackmail' to achieve the country's political goals.

The pretext, context, and the general tone of the mentioned letter, as well as a large number of factual errors and leaps in logic (a letter concerning gas supply stability should have been addressed to the management of a company engaged in gas purchasing and distribution rather than a network operator that owns pipes but not the gas running through them) demonstrate the irrationality and the self-contained feeling of imminent danger and instability coming from Russia, which is generated by the Estonian establishment.

It is worth stressing that Estonian politicians not only target their radical rhetoric at the country's population, but also call for the other EU members to act accordingly. First, it concerns the implementation of the Third Energy Package fervently supported by Estonia. In the past months, the Estonian strategy for implementing the Energy Package provision has drifted towards tightening the rules for the market players oriented to the Russian supplier — Gazprom.

[4] In September 2014, President T.H. Ilves stated that Estonia plans to become completely independent from the Russian energy system by 2025 [10].

Today, 37% of Eesti Gaas — Estonia's gas market operator — is owned by Gazprom. The same holds true for EG Võrguteenus providing services to the transmission networks of Eesti Gaas. At first, Estonia opted for the 'soft' variant of implementing the Energy Package provisions through establishing an independent gas or power transmission operator (a large company has the right to retain the ownership or management of gas distribution assets, however, these activities are tightly controlled). Now, the country is shifting to the 'hard' version — ownership unbundling (the networks are managed by an independent operator, whereas the joint stock cannot be owned by a company supplying or importing gas). This strategy was launched in the beginning of 2015, when Elering purchased 51% of EG Võrguteenus. At the same time, the company announced plans to buy out the stock of all other players — Latvia's Itera (10%) and Gazprom (37%). It is very likely that Gazprom will withdraw from the joint stock of Estonia's gas market operator Eesti Gaas.

This solution is motivated by not only solidarity with the European colleagues and the aspiration to meet all the requirements of the Third Energy Package, but also a clear goal — to prevent the Russian gas monopoly from influencing the decisions concerning the development of the gas transmission infrastructure in the region.

In this context, the situation is not favourable for the Baltics. Among the attempts at implementing infrastructure projects, one should mention the Estonian-Finnish dispute about the right to construct a LNG terminal in one of the countries and the gas pipeline Balticconnector in the Gulf of Finland. These infrastructure facilities played an important role in interconnecting the gas transmission networks of Finland, the Baltics, and Poland with the rest of Europe. If they are implemented, Estonia will gain access to gas from the floating LNG facility in Klaipeda built in 2014 (this gas will cost much more than Russian).

However, the dispute with Finland has not been settled. The European Commission considered building two terminals in both countries unreasonable; therefore, funds will not be allocated in this round of financing. The stumbling stone is the small size of Estonia's (and the Baltics') domestic market and the inability to ensure stable demand for gas from the new gas storage facility.

Therefore, Estonia does not seem to have a bargaining advantage in the forthcoming 2016 gas price negotiations with Gazprom. The prospect of constructing an LNG terminal in Estonia as an alternative gas source — if the project is supported — is rather distant. The possibility of interconnecting with the Latvian gas storage facility and operating on fuel oil was entertained before; however, they never served as a serious argument for dropping gas prices.

In general, the implementation of the Third Energy Package provisions facilitates competition between numerous regional infrastructure projects proposed by the Baltic and Nordic countries. However, due to the small size of their domestic markets, it results only in growing prices. The merging competition cannot be translated into consumer's benefit or the weakening of Gazprom's position.

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Over the past decade, each crisis in the already strained Russian-Estonian relations has urged the authorities on the either side to rectify mistakes. After the 2007 conflict, Estonian politicians started to pay more attention to protecting the interests of national large businesses when addressing political differences. The current crisis has shown pragmatism gradually replacing political emotions. However, miscalculated opportunities and misplaced expectations regarding the EU support did not prevent losses — ordinary consumers, small businesses, and farmers were affected.

As to Russia, the situation is developing differently. After the first conflict, it was decided to adapt business processes to the political situation. To this end (it is worth stressing that it will have a favourable effect on Russian business in a long-term perspective), the construction of the port of Ust-Luga, as well as other infrastructure objects on the Russian territory, was launched.

However, the current crisis presents Russia with challenges that are more serious: the disproportion of FDI is already tangible and it will only grow in the months to come. Interested in the increase in Russian investment in the neighbouring country, the Russian authorities have to ensure that this investment is a mutually beneficial process rather than the exodus of capital accompanied by the transfer of production and infrastructure facilities abroad. In view of Estonia's natural advantages (its geographical position, ethnic and language composition, and EU membership), it is worth keeping in mind the additional measures taken by the country's leadership to increase its investment attractiveness — tax privileges, e-residency for investors, and others. Obviously, these measures and Russia's 'worsening' economic outlook contribute to the competition of jurisdictions in the Russian North-West, and not to the country's benefit.

This article, prepared at the Institute of World Economy and International Relations of the Russian Academy of Sciences, was supported by a grant of the Russian Research Foundation (project No. 14-28-00097 'Optimisation of Russian foreign investment ties against the background of deteriorating relations with the EU').

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