

## ABSTRACT

*Analysing the evolution and determinants of foreign direct investment (FDI) in Estonia, Latvia and Lithuania, this paper argues that sound economic policies have created an environment conducive for FDI. Overall, FDI has contributed to economic growth in the Baltic economies, having financed around one-fifth of fixed investment. However, their small size makes the Baltic countries relatively less attractive for market-seeking FDI in manufacturing. Moreover, at the outset of transition, their economies were dominated by relatively uncompetitive low-technology industries, which made them less interesting for manufacturing-based export-oriented FDI. Thus, FDI largely went to relatively low-technology sectors, such as wood processing and food, and it has not helped radically transform the structure of the manufacturing sector. A major part of FDI went into services, including banking and telecommunication, contributing to increasing efficiency in the whole economy.*

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# FDI in small accession countries: the Baltic states

## 1. Introductory remarks

Estonia, Latvia and Lithuania are very small economies, with a combined population of just over 7 million and a GDP similar to that of Luxemburg. Having regained independence after the collapse of the Soviet Union in 1990-91, they are the only countries with such a background that smoothly integrated into Europe, finally joining the EU in May 2004. The geographical position between Russia and the rest of the EU gives them a bridgehead function, with Baltic Sea shipping linking them to the West more readily than overland routes.



*Gábor Hunya*

Although the outside world defines them as the Baltic region, these countries do not have a strong regional identity, with the possible exception of Latvia. Estonia considers itself mainly a Nordic country, closely linked to Finland and Sweden. Lithuania, on the other hand, considers itself central European due to its historic ties to Poland. Baltic Sea regional cooperation, supported by Denmark, seems to have little political and economic relevance (Jurkynas 2003). But recent history and the simultaneous accession to the EU put them under one heading, and joint EU accession will unavoidably bring them closer to each other in the future.

The transformation to a market economy proceeded fast on very liberal foundations in Estonia, followed later by Latvia and, more hesitantly, Lithuania. Due to this uneven development, only Estonia was considered for years a first-tier accession country. It was the Helsinki EU Council meeting in December 1999 that set the three countries on an equal footing, anchoring developments not only in Estonia but also in Latvia and Lithuania to the enlargement process. This contributed to an acceleration of transformation in Latvia and Lithuania, which have practically closed the gap in terms of institutional development to Estonia.

In per capita terms, the amount of inward foreign direct investment (FDI) in the Baltics is above the average of the new EU members from Central and Eastern Europe (CEE).<sup>1</sup> This is mainly the result of economic transformation, privatisation and a liberal, FDI-friendly environment. Most of the financial and the telecom sectors as well as a large part of the manufacturing sector are foreign-owned. Moreover, FDI is a factor integrating these countries more with their western neighbours than with each other although for many transnational corporations Estonia is a bridgehead for investments in the other two countries.

Notwithstanding the relatively high importance of FDI, there has been very little academic research on FDI in the Baltics. As one prominent analyst of the region, Pekka Sutela, notes: "Perhaps due to the small size of the Baltic economies and also reflecting the weakness of domestic economic research, little analytical literature is available on these countries" (Sutela 2001, p. 9.). While some research has been done on Estonia, the other two countries have attracted little outside interest. This paper attempts to systematise the

<sup>1</sup> In addition to Estonia, Latvia and Lithuania the new members are the Czech Republic, Hungary, Poland, Slovakia, and Slovenia.

available information on the Baltic countries, but obviously it cannot fill the wide research gap that exists given the absence of background research comparable in size and quality to that available for Hungary, for instance. The remainder of the paper proceeds as follows. Sections 2 and 3, respectively, examine the main features and determinants of FDI in the Baltic countries. Section 4 sheds light on the contribution of foreign-owned firms to economic activity. Section 5 offers concluding remarks and an outlook.

## 2. Main features of FDI in the Baltic countries

This section will analyse the importance of FDI for the Baltic countries (examining both inward and outward FDI as well as the contribution of net FDI inflows to the financing of current account deficits), the geographical origin of FDI, and the economic sectors that have been the main targets of foreign direct investors.

### 2.1 How important is FDI for the region?

*Although small in absolute terms, FDI flows to the Baltic countries have been substantial relative to the size of their economies.*

Small countries normally attract only small amounts of FDI in nominal terms unless they function as international headquarters. The experience of the three Baltic countries fits this image. In 2000-02, for instance, they received about 6-7 percent of the FDI inflows into the eight CEE countries that have joined the EU, and total inflows reached USD 1.4 billion in 2002.<sup>2</sup> However, amounts that seem insignificant in an international comparison can be very important for a small recipient country where FDI usually finances a large part of the current account deficit, is equivalent to some 20-40 percent of gross fixed capital formation, and helps access new technology and new markets.

Let us start with a look at per capita FDI inflows. Figure 1 shows that Estonia – the smallest of the Baltic countries in terms of both population and GDP – attracted the largest per capita FDI inflow in 1995-2002, averaging about USD 250 a year.<sup>3</sup> In fact, with the exception of the Czech Republic, no other new EU member from CEE received more FDI per capita than Estonia during these years. Obviously, period averages hide developments over time and, in fact, FDI inflows have been quite volatile. An important point to note is that Estonia started to receive FDI earlier than Latvia and Lithuania as it was, on the whole, more attractive than the other countries due to early market reforms, full-scale liberalisation, and equity-sales-based privatisation. However, in 2001-02, the two late-coming countries were catching up. More specifically, in 2002, Estonia and Lithuania each attracted FDI per capita of USD 210, and Latvia came a close second with almost USD 170. The recent decline in FDI flows to Estonia reflects world-wide problems in the electronics industry and a higher share of non-equity investments. Mid-2003 data suggest that FDI flows to Estonia have recovered, however.

<sup>2</sup> Unless otherwise indicated, FDI data are taken from central bank publications.

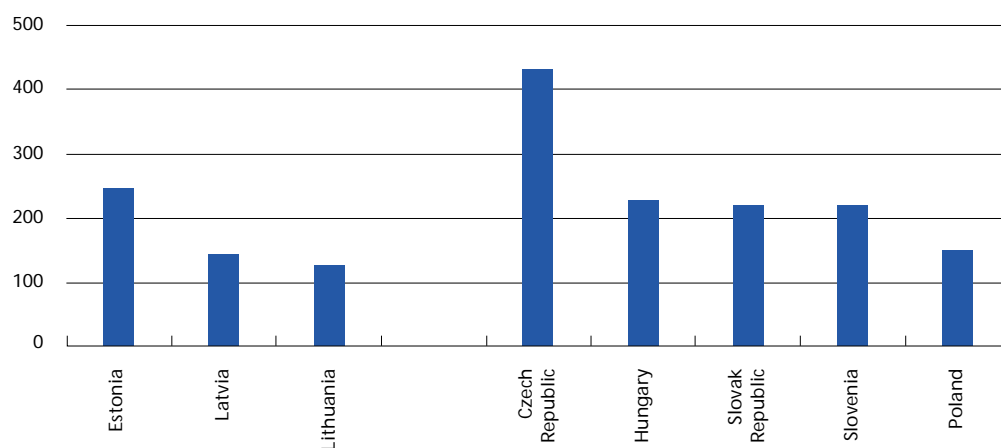
<sup>3</sup> It should be noted that FDI statistics for the Baltic countries are fully comparable only from 1997 onwards. In principle, FDI should include equity capital, reinvested earnings, and inter-company loans. Only the FDI data for Estonia include all items throughout the period considered here. In the case of Latvia, reinvested earnings and inter-company loans have been accounted for since 1996. In the case of Lithuania, reinvested earnings have been included as from 1995 and loans as from 1997.

A more general cause for the volatility of FDI inflows transpires when we consider the three forms of FDI: equity, reinvested earnings, and inter-company loans all follow a different pattern (see Annex Table A1). Privatisation-related FDI and new start-ups are usually in the form of equity. Profits are not made in the initial stage of the investment, but once they accrue, reinvested earnings normally contribute about 30 percent to FDI. To illustrate, in 2001, reinvested earnings amounted to 41 percent of FDI in Estonia, 36 percent in Latvia, and 19 percent in Lithuania. Given Estonia's head start, on the one hand, and Lithuania's late and slow accumulation of FDI on the other hand, the differences across countries in the relative importance of reinvested earnings are not surprising. What is more, when parent firms face financial difficulties, profit reinvestment declines and repatriation increases. This was the case, for instance, in 1998-99 when Scandinavian banks lost part of their investments in the context of Russia's financial crisis. To compensate for these losses, repatriated earnings from affiliates in other countries, including the Baltic countries, increased and thus reinvested earnings fell.

Inter-company loans are especially volatile. They can supplement equity investments in established subsidiaries, but they can also be an easy means of withdrawing capital. Large loan inflows in one year may be followed by high outflows in the next, as was the case in Latvia in 2001 and Lithuania in 1999. In Latvia, foreign banks consolidated banking and leasing operations, which required a large loan repayment to the foreign parent (IMF 2003). This caused a sizable drop in FDI. In Estonia, short-term inter-company loan inflows in 2001 were matched by outflows in 2002. Given the reasons for the volatility of inter-company loans and reinvested earnings, one has to be careful when interpreting fluctuations in overall FDI inflows. Clearly, swings in inter-company loans and reinvested earnings that are due to special events affecting parent companies should not be mistaken for a change in the attractiveness of the FDI receiving country.

*At times, the volatility of inter-company loans and reinvested earnings may have given a false impression of the underlying capacity of Baltic countries to attract FDI.*

**Figure 1. Average annual FDI inflow per capita in USD, 1995-2002**

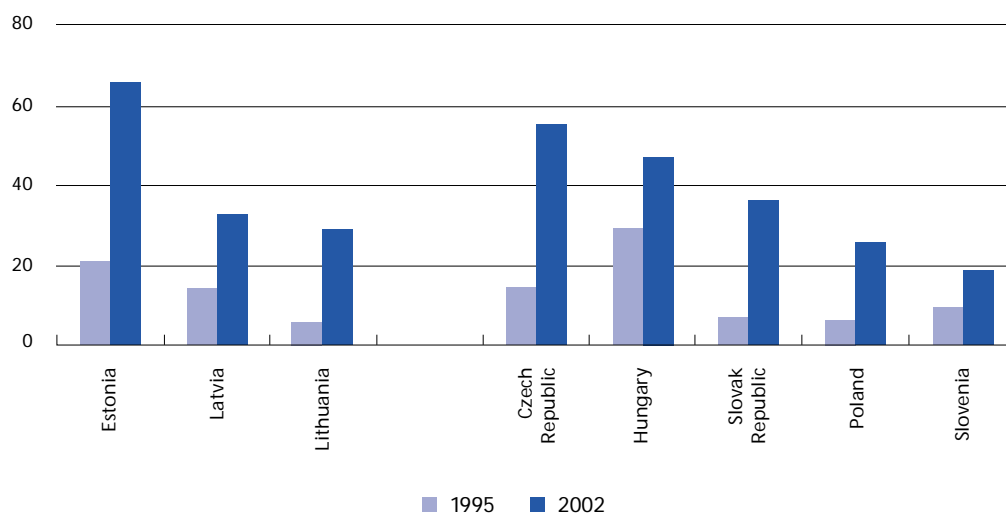


Source: Central banks.

The leading role of Estonia as a destination of FDI is also apparent when we use GDP instead of population to scale nominal FDI. This can be seen from Figure 2, which shows inward FDI stocks in percent of GDP for the beginning and the end of the period considered here.

In 2002, the inward FDI stock in Estonia was 66 percent of GDP, twice as high as in Latvia (33 percent) and Lithuania (29 percent). In all three countries, the stock of FDI (in percent of GDP) is above the world average.

Figure 2. Inward FDI stock in % of GDP, 1995 and 2002



Notes: FDI stock at end of period.  
Source: Central banks.

*Estonia has been able to attract FDI beyond the absorption capacity of its small market by serving as headquarter for Nordic firms operating in the Baltic region.*

Relatively high FDI in Estonia is a special case, difficult to achieve by the other countries. It reflects the attractiveness of one of the most open and foreign-penetrated economies in the world. Estonia has been able to attract FDI beyond the absorption capacity of its small market by serving as headquarter for many Nordic transnational corporations in their penetration to the other two Baltic countries. In spite of considerable progress in structural transformation in recent years, the other Baltic countries continue to be less attractive. They score worse than Estonia in all international rankings of economic freedom, corruption and credit rating. Their institutions are more cumbersome, more prone to corruption, and are from time to time hesitant in supporting FDI.

Turning to outward FDI, it is fair to say that small, low-income economies usually lack companies that can invest abroad. This is reflected by the very low outward FDI figures of Latvia and Lithuania. Latvia had some foreign assets in Russia at the time of independence, but they virtually disappeared in the wake of the Russian crisis.

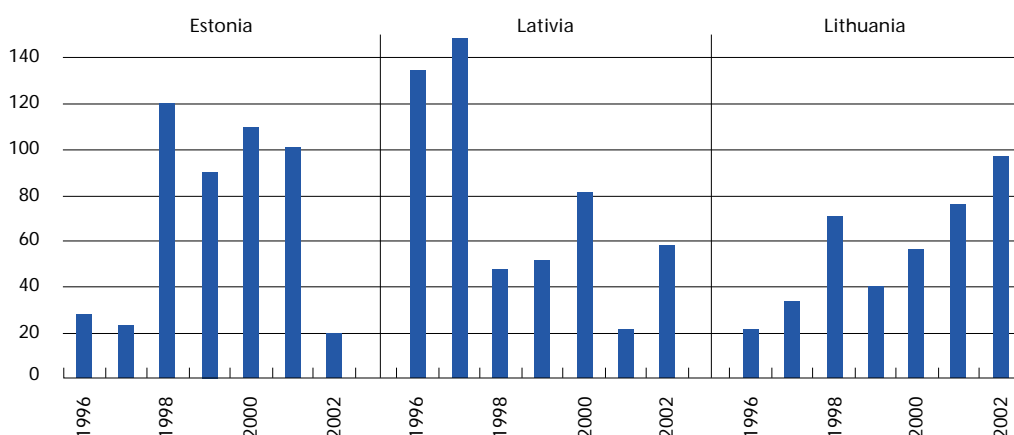
Estonia is an exception. Although small and comparatively poor, its outward FDI stock is significant relative to the size of the country, amounting to USD 500 per capita and around 10 percent of GDP. This puts Estonia together with Hungary on the top of the list of CEE countries that are providing FDI to the rest of the world. But the overwhelming part of Estonia's outward FDI is carried out by foreign affiliates. Three-quarters of its outward FDI stock is in Lithuania and Latvia, reflecting largely the fact that two Swedish banks expanded to the other Baltic states via their Estonian subsidiary. This also explains why most of Estonia's outward FDI stock lies in the banking sector. These investments are mainly in the form of loans and not of equity. Further FDI has taken place by Estonian affiliates of

foreign transnational corporations in the telecommunication sector, real estate, and in retail. Finally, a significant transport FDI is related to the merchant fleet registered in Cyprus (Varblane *et al.* 2001).

When assessing the importance of FDI, a question of particular interest is how much net FDI inflows (i.e. the difference between inflows and outflows) contribute to the financing of a country's external current account deficit. In all Baltic countries, net FDI inflows are of considerable importance for the financing of such deficits. Here one also needs to bear in mind that current account deficits are normally large in countries, such as the Baltics, that are trying to catch up with higher living standards elsewhere in the world. To illustrate, in 1996-2002, net FDI inflows averaged 60, 65, and 55 percent of the current account deficit in Estonia, Latvia, and Lithuania, respectively. But as Figure 3 shows, the ratio of net FDI to the current account deficit fluctuated substantially. This was due to annual variations in the size of both current account deficits and net FDI inflows.

*In all Baltic countries, net FDI inflows have contributed considerably to the financing of external current account deficits.*

**Figure 3. Net FDI inflows in % of current account deficit, 1996-2002**



Source: Central banks.

Apart from year-to-year fluctuations in the ratio of net FDI to current account deficits, one needs to be aware of longer-term effects of FDI on a country's external position. As and when the stock of FDI in a country is building up and if foreign investments turn out to be successful, earnings accruing to foreign investors will negatively affect a country's external current account. To the extent that these earnings are reinvested, the negative current account impact is offset by additional FDI inflows. But as we have argued above, most likely, not all earnings are reinvested and, moreover, reinvested earnings may fluctuate markedly.

Overall, developments in the ratio of net FDI inflows to a country's current account deficit depends on net inflows themselves and on the current account; the latter – in turn – not only reflects movements in exports and imports but also earnings accruing to foreign investors for earlier FDI inflows. A telling example is what happened in Estonia in 2001-02. As Figure 3 shows, net FDI in percent of the current account deficit dropped

from 100 to about 20 percent. Two factors combined to bring about this result. One was a sharp decline in net FDI inflows from about USD 340 billion in 2001 to USD 153 billion a year later. The other factor was a doubling in Estonia's current account deficit to the equivalent of 12<sup>1</sup>/<sub>2</sub> percent of GDP. But what was behind this large current account deterioration? For one thing, earnings of foreign investor increased sharply from some USD 70 billion to USD 170 billion, thus surpassing net FDI inflows. For another, exports stagnated and imports boomed.

While 2002 was an exceptional year for Estonia, it is nevertheless a reminder that FDI is not a free lunch: it is a profit-bearing investment for the foreign company. A country can expect profits to be reinvested only if it maintains its long-term attractiveness for FDI. Even then, an international economic downturn or financial difficulties for the investor elsewhere can lead to withdrawals. Under such circumstances, high current account deficits may become a problem.

## 2.2 Where do FDI inflows come from?

*Small countries usually attract foreign direct investors from their richer neighbours, but not necessarily the largest transnational corporations.*

Small countries usually attract investments from their richer neighbours. Moreover, as cheap assets and small markets require small amounts of investments, the largest transnational corporations may have little interest to invest in such countries in contrast to regional players. Austrian firms are a case in point, accounting for a high share in the inward FDI of small neighbouring countries like Slovakia and Slovenia.

The importance of foreign investors from neighbouring countries is most visible in the case of Estonia, where more than two-thirds of the inward FDI stock stems from Sweden (41 percent) and Finland (27 percent) while the third largest investor, the United States accounts for only 7 percent of the inward FDI stock (see Table 1). Overall, foreign investors

**Table 1. Inward FDI stock of Baltic countries by major investing country (2002)**

	Estonia		Latvia		Lithuania	
	USD million	% of total	USD million	% of total	USD million	% of total
Nordic countries	3,127	74.0	1,182	43.0	2,122	53.3
Finland	1,153	27.3	197	7.2	246	6.2
Denmark	106	2.5	301	10.9	683	17.2
Sweden	1,731	41.0	331	12.0	609	15.3
Norway	137	3.2	189	6.9	117	2.9
Estonia	.	.	164	5.9	467	11.7
Germany	97	2.3	346	12.6	382	9.6
United Kingdom	93	2.2	117	4.3	214	5.4
USA	300	7.1	193	7.0	345	8.7
Russia	52	1.2	136	4.9	208	5.2
Netherlands	167	3.9	132	4.8	240	6.0
Other	392	9.3	646	23.5	471	11.8
<b>TOTAL</b>	<b>4,226</b>	<b>100</b>	<b>2,751</b>	<b>100</b>	<b>3,981</b>	<b>100</b>

Note: Numbers may not add up due to rounding.  
Source: Central banks.

from Nordic countries account for around three-quarters of Estonia's inward FDI stock. In Latvia, the sources of FDI are more diverse, with Denmark, Sweden, but also Germany – for instance – each representing 11-13 percent of the FDI stock. The share of the Nordic region comes to around 43 percent. In Lithuania, Denmark comes first on the list with 17 percent, followed by Sweden (15 percent) and Estonia (12 percent). Overall, investors from the Nordic region account for 53 percent of FDI in Lithuania.

There is something to be said about the role of Russian firms as foreign investors in the Baltic countries. Although Russia is a neighbour, who controlled these countries when they were part of the Soviet Union, Russian firms do not appear as significant investors (5 percent or less of the FDI stock in all three countries). It seems fair to claim that, for historical reasons, governments of the Baltic countries are wary about too large an influence of Russian investors and, in fact, hinder them in penetrating. Privatisation conditions are usually formulated in a way that virtually shuts out Russian investors.

*All Baltic countries are concerned about too large an influence of Russian investors; but to benefit from their geographical position, they may have to adopt a more open stance.*

But this has had, at times, negative repercussions on the Baltic economies or eventually proved ineffective. For instance, in Latvia, the transit oil pipeline was put up for privatisation, but when Russia's Transneft was not declared the winner, it stopped exporting oil through the pipeline. The pipeline closed down, forcing Latvia to import oil by rail at much higher transport costs. Hostilities prompted Russia to build a new oil exporting harbour near St. Petersburg, which drained some of the transit revenues of the Baltic countries.

In Lithuania, a prominent case shows that hindering Russian investors may turn out to be futile. In October 1999, Lithuania concluded a controversial USD 150 million agreement to sell Williams International (a US firm) a 33 percent stake in Mazeikiu Nafta.<sup>4</sup> The deal gave Williams – which pledged to invest another USD 650 million – operational control of the refinery, pipeline, and the crude oil terminal. In addition, Williams acquired the right to buy a majority stake within five years. In addition to opposition from Lithuania's citizens, upset at the terms of the sale, the Russian oil giant Lukoil was dismayed to have been shut out of the partial privatisation. Lukoil, the coordinator of Russian oil exports to Lithuania, promptly began reducing oil supplies to the only refinery in the Baltic states. Oil shortages caused several shutdowns and losses to the refinery in 2000. In June 2001, Williams reached an oil supply deal with Yukos, alleviating some of the supply problems, but Mazeikiu Nafta continued to make losses. A year later, Yukos acquired a 27 percent stake in Mazeikiu Nafta, becoming an equal partner with Williams (whose stake in the company decreased to 27 percent while the Lithuanian government's stake decreased from 59 to 41 percent). The co-habitation of the two foreign owners lasted only until September 2002. Yukos bought out Williams' stake and took over management rights and operational control. It started boosting crude supplies to the refinery and made it profitable.

In sum, investors from neighbouring, mainly Nordic, countries account for the bulk of FDI in the Baltic countries. For historical reasons, investors from Russia are not particularly welcome. But if Baltic countries want to benefit more from their geographical position, they will have to accept prudent Russian investors.

<sup>4</sup> The following is based on information posted on the website of the US Energy Information Authority (<http://www.eia.doe.gov/>).

### 2.3 Which economic sectors attract FDI?

The secession from the Soviet Union, the 1998 Russian crisis, and market economy conditions drove much of the manufacturing companies out of business in the Baltic countries. Switching markets and quality requirements proved impossible for most of the companies producing consumer goods. A prominent example is the Latvian electronics industry, which had a fairly good reputation before the collapse of communism. Following sharp contraction in the early years of transition, industrial recovery has been relatively slow. Several small and medium-sized companies have been established either “greenfield” or following the break-up and privatisation of former state-owned enterprises, but overall, the share of manufacturing in GDP is relatively small, and services account for the largest and most dynamic part of economic activity.

*Reflecting the structure of the Baltic economies, service sectors have attracted the bulk of FDI.*

The sectoral distribution of FDI reflects the structure of the Baltic economies. As Table 2 shows, service sectors – such as transport, telecommunications, business services, and finance – have attracted the bulk of FDI. The high share of FDI related to transport, storage, and telecommunication is specific to the region. It is due to the transit position of the Baltic countries: Russian commodities are exported through Baltic Sea ports. Telecommunication enterprises were privatised to foreign investors in all three countries, and essential parts of the energy sector, including gas transport and distribution, are about to be privatised to foreign investors too.

**Table 2. Share of economic activities in the FDI stock (2002), in %**

	Estonia	Latvia	Lithuania
Manufacturing	18.8	15.2	29.3
Electricity, gas	2.9	3.7	3.6
Construction	2.5	0.8	1.1
Trade	13.5	17.3	17.3
Hotels	1.3	1.5	1.5
Transport, telecom	21.4	14.1	17.1
Finance	28.0	15.7	20.0
Business services	9.5	23.8	7.1
Other	2.1	7.9	1.8
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Note: Numbers may not add up due to rounding.

Source: Central banks.

Financial intermediation is another service sector that has attracted considerable interest of foreign investors, accounting for 16-28 percent of total FDI. In this context, it is interesting to note that before the Second World War, Riga (the Latvian capital) used to be the financial hub of the region; now it is Tallinn, the capital of Estonia. In the banking sector foreign control is almost complete: about 90 percent of the banking assets are held by foreign subsidiaries. The credit expansion to the private economy is still meagre, but spreads have decreased after the privatisation of banks to Scandinavian banks. Banks in Baltic countries have also attracted deposits from Russia and Belarus, both having less reliable banking systems.

Turning to manufacturing, it is fair to say that FDI inflows were not able to stage a recovery of this sector and, thus, did not reverse the deindustrialisation of the Baltic countries. The share of manufacturing in the stock of inward FDI ranges from 15 percent in Latvia to 29 percent in Lithuania, where manufacturing has been growing more rapidly than in other Baltic countries.

Most of the manufacturing FDI is in low-tech sectors of wood processing (including paper and furniture) and food. These two industries received almost 40 percent of the manufacturing FDI in Estonia and 47 percent in Latvia. While the food industry mainly targets the local market, exports of the wood processing industries are substantial. In Lithuania, which is more abundant in agricultural land but less in forests, 38 percent of manufacturing FDI is in food processing. The chemical industry comes second (24 percent) due to one oil refinery that refines Russian oil for export. Textiles and clothing FDI represent about 10 percent of manufacturing FDI in all three countries. New greenfield investments in this sector are export oriented, especially in Lithuania and Estonia.

*Low-tech activities, such as wood and food processing, account for most of the FDI in manufacturing.*

Higher value added sectors of machinery, electronics, and transport equipment have a combined manufacturing FDI share of 13 percent in Estonia but only 8 percent in Lithuania and Latvia. Some of the foreign subsidiaries in high-value-added manufacturing have become increasingly export oriented, like the Finnish electronic equipment producers in Estonia.

To summarise the main features of FDI in the Baltic countries, it should first be noted that inward FDI plays an important role in all of them, Estonia being the leader. Second, reflecting geography, investors from Nordic countries account for the bulk of the inward FDI to the Baltic region. Finally, non-tradable services have attracted most of the inward FDI while there has been relatively little foreign investment in manufacturing; deindustrialisation associated with the output collapse in the early phase of transition and the small size of the Baltic market probably explain moderate FDI in manufacturing.

### **3. Main factors attracting FDI**

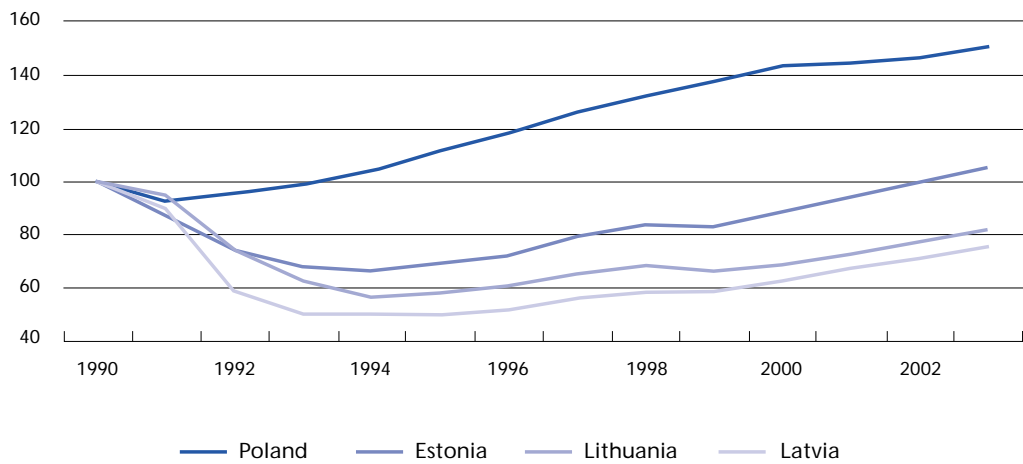
#### **3.1 Favourable macro-economic environment**

Stable and growing economies provide a good environment for domestic and foreign investment activity. One of the reasons Baltic countries have been successful in attracting FDI is that they opted for radical market reforms that led to the rapid creation of functioning market economies.

The transformational recession in the early 1990s, amplified by the secession from the Soviet Union, was reflected in a significant fall in GDP. As Figure 4 shows, Estonia reached the bottom of the recession in 1994, with real GDP amounting to 66 percent of the level in 1990. Lithuania reached the turning point in the same year, but experienced a larger output contraction (real GDP equivalent to 56 percent of 1990 level). Latvia was most severely hit, as real GDP stagnated at around 50 percent of the pre-transition level through 1993-95.

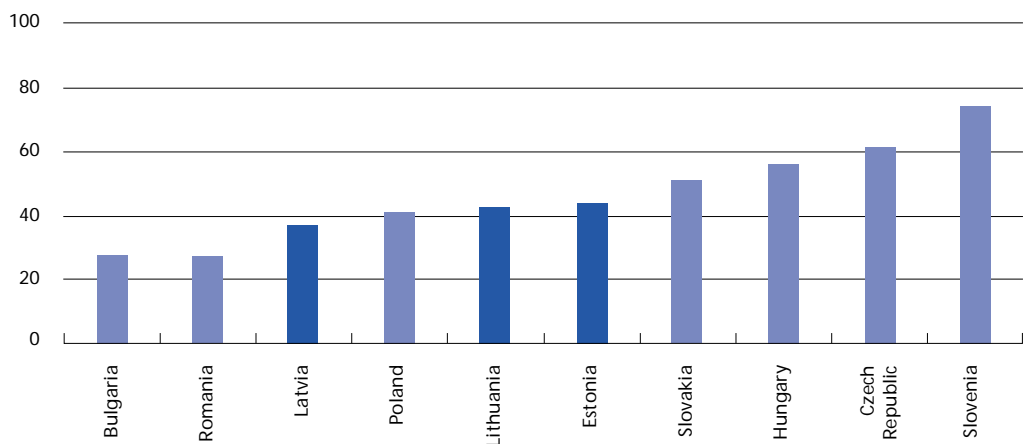
Economic growth resumed around 1995 and was only interrupted in 1999 due to the Russian crisis. As a result, between 1995 and 2003, per capita GDP (in terms of purchasing power parity) increased by at least ten percentage points, indicating a fast catching-up process. Figure 5 shows that Estonia's per capita GDP (in terms of purchasing power parity) is now equivalent to around 45 percent of the EU average, which puts Estonia ahead of Lithuania (43 percent) and Latvia (37 percent).

**Figure 4. Real GDP index for the Baltic countries and Poland (1990= 100)**



Source: wiiw database.

**Figure 5. GDP per capita in CEE countries (in % of EU-15 average, 2003)**



Note: GDP measured in purchasing power parity standards.

Source: European Commission.

In all Baltic countries, exchange rate stability contributed to an environment conducive to FDI. Exchange rate stability was achieved in similar ways: Estonia introduced a currency board in 1992, followed by Lithuania in 1994; Latvia pegged its exchange rate to the SDR

(a change to the euro is planned for 2005 when the country plans to participate in the European Exchange Rate Mechanism, ERM-II). Under the fixed rate regimes, inflation came down and it is close to the EU-15 average. To support the viability of their fixed exchange rate arrangements, all countries have maintained low budget deficits.

To summarise the macroeconomic environment that provided the backdrop for FDI in the region: of the three Baltic countries, Estonia went through the mildest transformational recession and has maintained its advantage since the recovery began in the mid-1990s. While all Baltic countries have made considerable progress in catching up with higher living standards in the EU-15, only Estonia has reached its pre-transition per capita GDP, the other two countries are still about 20 percent below that level. All countries pursued fiscal policies that ensured the viability of their fixed exchange rate arrangements and, thus, a favourable investment climate.

### 3.2 Role of privatisation mainly indirect

In transition economies, the issues surrounding the privatisation of state-owned enterprises have stretched far beyond concerns about a possibly excessive involvement of foreign investors in the domestic economy. A total overhaul of property rights that took place in just about a decade created an unprecedented redistribution of wealth. Social equity considerations suggested a wide distribution of property among the population while efficiency and investment needs made a takeover by a strategic investor desirable. Given the main focus of this paper, we shall not go into details of the privatisation process but only evaluate it in terms of how much and what kind of FDI it attracted.

Examining the period 1994-98, Hunya and Kalotay (2000) find that about half of the FDI inflows to transition countries were directly (privatisation revenues) or indirectly (restructuring investment) linked to privatisation. The method and sequencing of privatisation decided over the size and timing of FDI directly related to privatisation. Estonia decided in 1993 in favour of direct sales, considering this an effective way of making the country an attractive place for investment. But assets were very cheap and, thus, privatisation revenue accounted for only 17 percent of the FDI inflows. Latvia initially privatised by lease and vouchers to domestic investors, excluding foreign investors. When sales to foreigners became more frequent, FDI inflows directly linked to privatisation increased, but nevertheless accounted for only about 25 percent of total FDI inflows in 1994-98 (Sutela 2001). In Lithuania, voucher privatisation dominated until the mid-1990s. But a few larger companies in industries with international dominance of multinationals (e.g. tobacco and confectionary) were sold directly to foreign investors. In all three countries, FDI directly linked to privatisation concentrated to some extent in specific years, reflecting the sale of major state assets. Worth mentioning are the selling of banks in Latvia in 1997 and the privatisation of telecoms in Lithuania in 1998.

*The method and sequencing of privatising state-owned assets determined the size and the timing of FDI directly related to privatisation.*

In general, the amount of FDI directly linked to privatisation depends on whether or not the government tries to restructure state-owned enterprises prior to privatisation. Restructuring before privatisation could increase the viability of a company and thus its sales. In practice, however, the state usually generates more revenues by privatising companies fast without prior restructuring. A possible exception is the privatisation of banks, which often require some restructuring and recapitalisation before privatisation.

Another factor that influences privatisation-related FDI inflows are preferences granted to the new foreign owners. For instance, there have been cases where the privatisation contract provided the investor a temporary protection against competitors. This was done usually in exchange of employment guarantees, investment commitments or a higher sale price. For instance, in the case of the Lithuanian telecom company, amendments to the law on telecommunications were passed granting the company monopoly rights in terrestrial communications. Another case is the Mazeikiu Nafta oil company in Lithuania where the government offered loans and loan guarantees to the privatised company. In addition, the government reduced tariffs for using the Klaipėda Oil Terminal and the Lithuanian Railways, and it offered to increase import duties on fuel, if necessary (Bogdanovicus 2000).

### 3.3 Local markets or exports?

Export-oriented subsidiaries are set up by a vertically integrated transnational corporation in a host country with the aim of reducing production costs or finding secure and diversified resources (Narula and Dunning 2000). In essence, export-oriented FDI results in a geographical fragmentation of production processes. The important location factors that influence this type of FDI include labour costs, factor endowment – including natural resources – trade and exchange restrictions, and transport cost. Local market-oriented FDI is set up by horizontally integrated transnationals to penetrate a market, increasing market share, diversifying the source of sale, and minimising competition risk (Zhang and Markusen 1999). Important determinants of this type of FDI include local market size, trade barriers, the level of human capital, political stability, and cultural barriers. For both types of FDI, the quality of infrastructure and the policies towards FDI are of importance.

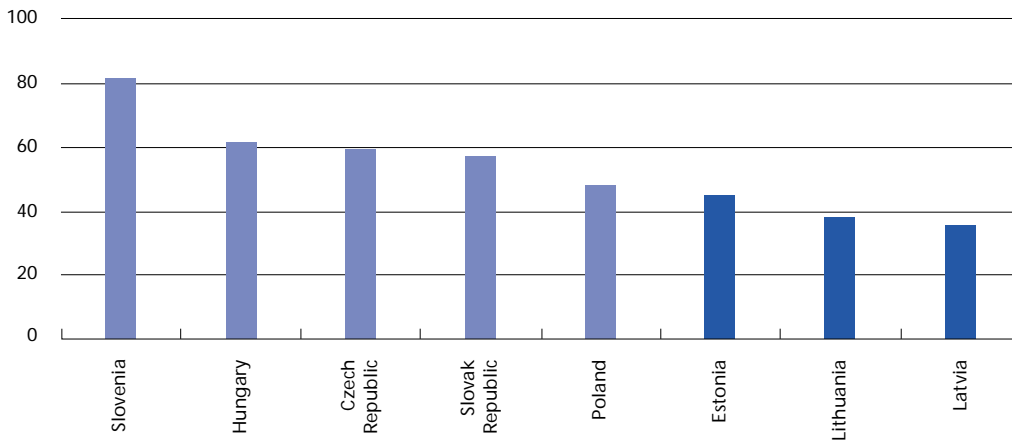
To start with factors important for attracting export-oriented FDI, labour costs in the Baltic countries are low compared to neighbouring EU-15 countries. To illustrate, average monthly wages amount to EUR 400 in Estonia and EUR 300 in Latvia and Lithuania, implying the lowest wages in the new EU member countries. Baltic countries should thus have a good chance of attracting labour-intensive FDI. In fact, as wages in the Baltics are significantly lower than in Poland, for instance, there is scope for a shift of labour-intensive production to the Baltic region.

*Low productivity of industrial production is a major problem in the Baltic countries.*

But as Konings (this volume), for instance, emphasises, labour costs must be assessed together with productivity levels. Low productivity of industrial production is a major problem in the Baltic countries, reflecting a lack of modern capital stock and the specialisation in low-tech industries with relatively low productivity levels. As Figure 6 shows, the Baltic countries have the lowest level of macroeconomic productivity of all new EU members from CEE, with productivity in Estonia, Lithuania, and Latvia, respectively, amounting to 45, 38, and 35 percent of the EU-15 average. Due to low productivity, unit labour costs in the Baltic manufacturing industry are relatively high. In Estonia and Latvia, they amount to 40 percent of the Austrian level, and in Lithuania to 32 percent. For comparison, in Hungary and the Czech Republic unit labour costs amount to less than 30 percent of the Austrian level, while in Romania and Slovakia they stand at about 20 percent (Landesmann and Stehrer 2003).<sup>5</sup> Thus, compared to other new EU members from CEE, Estonia and Latvia do not appear to be very attractive low-wage countries, and only Lithuania seems to be competitive in terms of unit labour costs.

<sup>5</sup> Figures are for 2001 based on 1999 purchasing power parity exchange rates.

**Figure 6. Macro-productivity in selected CEE countries (in % of EU-15 average, 2001)**



Note: Macro-productivity measured as GDP (at purchasing power parity exchange rates) per employee.  
Source: wiiw database and OECD.

But unit labour cost is only one factor that influences export-oriented FDI. Other important factors are the cost of transportation to export markets and the level of taxation. Estonia in particular has benefited from its proximity and low transport costs to Finland. Its relatively low corporate taxes have been another cost advantage. Furthermore, in terms of investment promotion, local business environment, and quality of public governance, Estonia fares better than the other two countries (see also the Section 3.4). These factors compensate for Estonia's higher unit labour cost.

Turning to market-seeking FDI, due to the small size of the Baltic states, their potential to attract large assembly-type investments is limited. Larger countries, such as Poland, have an advantage in attracting such investment (Michalowski 2003) even if one considers that the term 'market-seeking' does not only apply to the market of individual Baltic countries but to the region as a whole (Varblane 2000). Better prospects exist for small-scale FDI that targets a narrow market segment. But even here the cost of local production can be high, making imports more likely than local production.

*The small size of the Baltic countries limits the scope for market-seeking FDI.*

Given the limited scope for market-seeking FDI in the production of tradable goods, most of the FDI in the Baltic countries is in the non-tradable services sector. Only a low, but undisclosed part of services are internationally oriented. This is more visible in the transportation and export logistics provided to Russian firms; it is less visible in the banking sector where a significant part of the deposits probably stems from CIS countries.

Both market-seeking and export-oriented FDI to the Baltic countries seem to be hindered by a lack of suitable labour. For instance, survey results in Estonia (Varblane and Ziacik 2001) indicate that in a number of cases, the labour force has not lived up to its reputation. Initially, Estonia was able to offer skilled labour, but by the late 1990s the available skills did not match investors' needs. Continued dissatisfaction is likely because the educational system had not been reformed to reflect the changing needs of employers. This may also be generalised to other Baltic countries whose manufacturing seems to be locked into low value-added production. Looking at trends in the structure of labour

supply, it appears that a good part of the young generation does not see a future in becoming skilled factory workers. By contrast, the service sector can draw on a pool of well-educated people, making the outlook for FDI in services much brighter than for manufacturing.

### 3.4 FDI promotion policy

*Foreign direct investment promotion policies have been of secondary importance in all Baltic countries.*

It is fair to state that direct investment promotion policies have been of secondary importance in all Baltic countries – in contrast to other CEE countries such as the Czech Republic and Hungary.<sup>6</sup> In the last few years, there have been no tax breaks or direct subsidies available for foreign investors only. If such incentives exist, they apply to both foreign and domestic investors. The main policies to attract FDI have included macroeconomic stabilisation, structural reforms, the creation of a business-friendly environment, and privatisation. FDI promotion agencies have played an active role in promoting the country, coaching investors, and initiating improvement in economic legislation. That said, one has to keep in mind that privatisation contracts often included features aimed at enticing FDI.

While tax policies do not discriminate between foreign and indigenous investors, they are nevertheless surrounded by controversy. There is tax competition among the three countries, especially corporate income taxes have been reduced. There is an ongoing debate concerning the effects of these tax reductions on public services and investment. In the case of Latvia, for instance, the IMF suggested that the reduction of the corporate income tax from 19 percent to 15 percent, planned for 2004, be postponed to contain the budget deficit (IMF 2003). In the event, Latvia went ahead with its tax reduction plan to gain a competitive edge over its neighbours. Tax issues are also controversially debated in Estonia. For instance, in late 2003, the Estonian government coalition was about to split due to the debate on the level of the flat personal income tax. Advocates of social policies called for budgetary expenditure and disagreed with those who argued that lowering taxes was the best way to enhance competitiveness.

Let us now take a closer look at investment conditions in each of the Baltic countries.

#### 3.4.1 Estonia

Estonia has no exchange controls or restrictions on foreign investment. The amount of foreign capital invested in Estonian enterprises is unlimited, and full foreign ownership is permitted.

The principle of equal treatment of foreign and domestic investors has always been important and led to the abolishment of tax holidays for foreign investors as early as 1994. As of January 2000, the corporate income tax on re-invested profits (of foreign-owned and indigenous firms) was abolished in order to keep returns on FDI in the country. As a result, reinvested earnings increased in subsequent years. The withholding tax on distributed profit is 26 percent, equal to the flat tax rate on personal income.

<sup>6</sup> Information on FDI policy and incentives relies on the websites maintained by the investment promotion agencies in the respective countries and on UNCTAD (2002).

As there have been no customs duties imposed until recently (when the external border of EU became operational), Estonia has been an export-processing zone. It also provides a relatively easy administrative environment and relatively good infrastructure for investors. Infrastructure has been more readily available in the capital city (Tallinn), where the large majority of inward FDI concentrates. To promote a regionally more balanced economic development, an amendment to the income tax law was adopted in 1997, allowing the government to determine tax concessions for investments in backward regions to both foreign and domestic investors. Companies can deduct expenses made to acquire or upgrade fixed assets and equipment from taxable income provided that assets were acquired or upgraded in a region other than Tallinn and its neighbouring districts (Varblane and Ziatick 2001).

The Estonian Investment Agency (EIA) was established in 1994 as a governmental body with the remit to market Estonia as a stable business environment. It was turned into Enterprise Estonia in 2002 stressing its wider prerogatives in business promotion. For foreign investors it is a classic 'one stop' centre for information and support. Its function is to provide investors with all required information to evaluate investment opportunities in Estonia and help from the beginning of an investment to its completion.

In their analysis on the Estonian FDI policy Varblane and Ziatick (2001) suggest that the Estonian government should devote more attention to eliminating, or at least reducing, the bureaucracy associated with purchasing land, obtaining work and residence permits, and repaying VAT to exporters. Moreover, the government should also work to reduce corruption surrounding these procedures. Improvements in public governance can always be beneficial, but among the Baltic countries, these problems are the least pressing in Estonia.

### 3.4.2 Latvia

Foreign investors get national treatment, and they are free to engage in any activity, convert and transfer their earnings. Companies established before 1995 received 4-8 years tax holidays. Since 2001, large investments – both domestic and foreign – are eligible for corporate income tax holiday of up to 40 percent of the invested amount, in line with the limit set by EU competition rules. Companies manufacturing high-tech products enjoy a tax holiday of 30 percent of the investment; in the case of small and medium-sized enterprises it amounts to 20 percent. The corporate income tax rate has fallen gradually, reaching 15 percent in 2004. The withholding tax on dividends amounts to 10 percent. There is a flat personal income tax.

*In all Baltic countries, foreign and domestic investors are now treated equally.*

There are start-up supports in the framework of regional and labour market policies available for all companies. The Regional Development Fund of the Ministry of Economics compensates loan interest payments for companies establishing new employment-generating operations in regions with special support status.<sup>7</sup> Employers hiring new employees and providing training for them can receive training grants amounting to 70 percent of direct training costs. Losses can be carried forward for 5 years for

<sup>7</sup> See Ministry of Economics, Republic of Latvia (2003).

tax purposes. Double declining depreciation rates of up to 70 percent are applied for technological equipment.

Regional and local authorities may provide or sell land and real estate under favourable conditions to companies intending to create employment. Several local authorities in Latvia have established or intend to establish below market-price industrial estates to provide cheap land for greenfield investment. They can also grant up to 90 percent property tax reduction for investment projects conforming to their local/regional development strategies.

There are four special economic zones across the country, three of which are located in the free ports of Ventspils, Riga and Liepaja – the fourth being an inland zone in the city of Rezekne (located in Eastern Latvia, close to the Russian and Belarus borders). It took two years of negotiation with the European Commission to allow the operation of the zones after EU accession until 2017. Latvian authorities consider this a big achievement that would help the country to improve its FDI position.

### 3.4.3 Lithuania

The goal of attracting foreign investment was set by Lithuania shortly after it regained its independence. The first law on foreign investment was adopted on 29 December 1990. In mid-1995, Parliament enacted an updated version of it. The latter was replaced in 1999 with the Law on Investments applicable to foreign and domestic owned companies alike. Lithuania was thus the last Baltic country to provide national treatment and full freedom to foreign investors.

Furthermore, Lithuania no longer offers other incentives to foreign direct investors. Earlier incentives, introduced in 1993, were eliminated as of 1 April 1997. For investments made prior to that date, preferential tax treatment ceased to apply at end-2003.

*All Baltic countries have relatively low corporate profit taxes.*

The normal corporate tax rate is 15 percent, and the withholding tax rate on dividends is 15 percent. A zero-percent tax rate applies to companies producing agricultural products and to specialised enterprises rendering services to agriculture. A 13-percent corporate tax rate is levied on small companies.

The main investment incentives are those provided by the duty free economic zones of Siauliai and Klaipeda, as well as the industrial zones of Kaisiadorys and Utena. They can be maintained after EU accession. These regions provide the foundation of Lithuania's export-oriented manufacturing, emerging in the electronics, food, and chemical industries. Incentives applicable to enterprises operating in duty free economic zones are: a 50-percent reduction in land rent, a 80-percent reduction of profit taxes payable for the first 5 years, and a 50-percent reduction for the following 5 years. Investors with a minimum investment of USD 1 million are exempt from profit tax for the first 5 years, and a reduction of 50 percent is provided for the next 10 years. In addition, customs duty, VAT, excise tax, and withholding tax do not apply.

The most significant organisation promoting investment is the Lithuanian Development Agency (LDA). LDA supplies general information on the business climate and assists foreign

investors in gathering specific information. LDA also provides a variety of investor services and helps articulate and promote the interests of foreign investors through direct contact with the government.

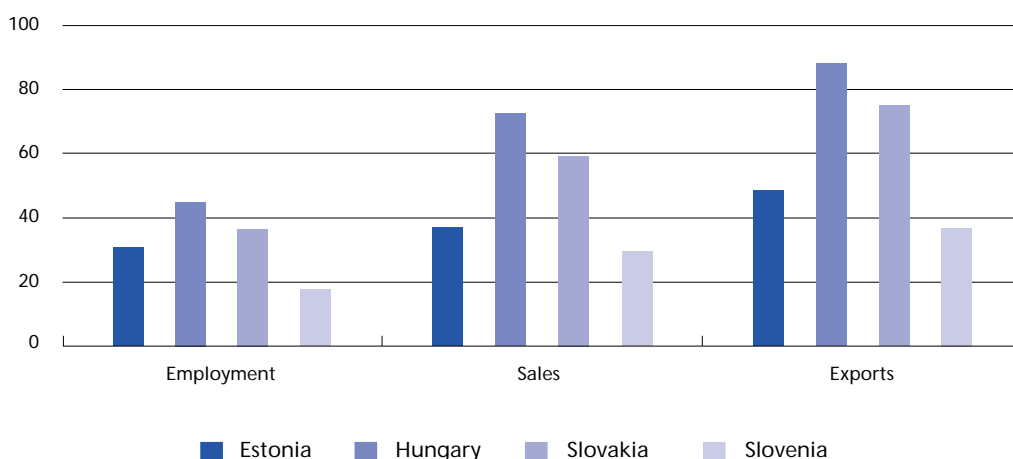
#### 4. The importance of foreign-owned firms in economic activity

Empirical evidence from broad-based country studies suggest that FDI has a positive impact on economic growth, restructuring, and competitiveness – both directly through the transfer of capital and knowledge to foreign-owned firms and indirectly through spillovers to the domestic sector. The Baltic states are fast growing economies and also host above-average amounts of FDI (relative to GDP). The coincidence of rapid growth and substantial FDI suggests that FDI has indeed helped the economic transformation and competitiveness of firms. However, the link between economic growth and FDI has not been thoroughly investigated. This section tries to shed some light on the link. First, we examine the role of foreign-owned firms in manufacturing employment, sales and exports. Then we take a brief look at productivity differences between foreign-owned and indigenous firms.

*The coincidence of rapid economic growth and substantial FDI inflows suggests that FDI has helped to transform the Baltic economies.*

The size of the inward FDI stock, as discussed in Section 2, gives some idea about the importance of foreign investment in an economy. However, it does not reflect the actual role of foreign firms in an economy. To learn more about this role, one needs to look at other indicators, notably the contribution of foreign-owned firms to output, exports, and employment (Hunya 2000). However, data showing the share of foreign-owned firms in output, exports, and employment are not available from statistical offices. This section draws on Hunya (2001 and 2003), who compiled such data for selected CEE countries, including one Baltic country, Estonia.

**Figure 7. Share of foreign-owned firms in manufacturing employment, sales, and exports in 2001 (in %)**



Note: For Hungary and Slovenia, data cover all firms; for Slovakia and Estonia, data include only firms with more than 20 employees; foreign-owned firms are those with at least 10% foreign ownership, except for Estonia where this threshold is 50%.

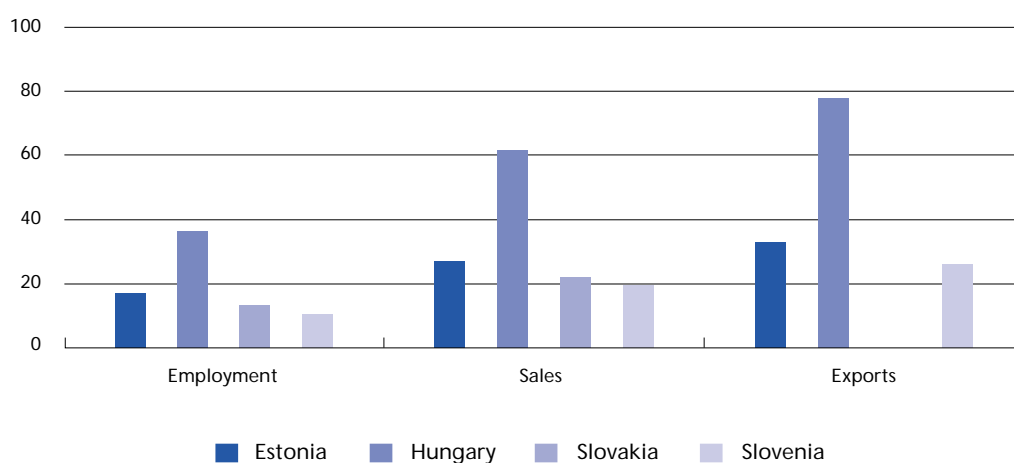
Source: wiiw database.

An observation to start with is that in Estonian manufacturing, foreign-owned firms are significantly bigger than domestic firms. The share of foreign-owned enterprises in the total number of firms with more than 20 employees is about 10 percent. But as Figure 7 indicates, they employ 31 percent of the manufacturing work force, produce 37 percent of sales, and account for almost half of manufacturing exports. As Figure 7 also shows, this suggests that the role of foreign-owned firms is less important in the Estonian economy than in Hungary and Slovakia.<sup>8</sup>

*There is evidence for an increasing role of foreign-owned firms in economic activity.*

Figure 8 shows the same information, but for 1996 instead of 2001. Evidently, the contribution of foreign firms to economic activity in manufacturing increased in all countries. But it is also true that the rise of foreign firms has been more pronounced in Slovakia (and there is evidence that this also applies to the Czech Republic). In part, the slower increase in the share of foreign firms in Estonia and Hungary is because both countries opened their economies earlier to foreign investors, attracting FDI ahead of the Czech and Slovak Republics. Another reason for the moderate increase in the share of foreign-owned firms in Estonian manufacturing is that not only foreign affiliates increased sales, employment, and exports, but indigenous firms expanded as well. In this context, it is worth recalling that Estonia recovered fast from the output trough in 1994. Furthermore, it seems that the radical transformation policy and the creation of a business-friendly environment benefited both foreign and domestic investors in Estonia, while in many other CEE countries incentives benefited mainly the foreign investors.

**Figure 8. Share of foreign-owned firms in manufacturing employment, sales, and exports in 1996 (in %)**



Note: For Hungary and Slovenia, data cover all firms; for Slovakia and Estonia, data include only firms with more than 20 employees; foreign-owned firms are those with at least 10% foreign ownership, except for Estonia where this threshold is 50%.

Source: wiiw database.

<sup>8</sup> Data for Estonia somewhat underestimate the size of the foreign sector in comparison to other CEE countries. This is because data for Estonia includes only majority-owned foreign firms with at least 20 employees. In the other countries the foreign ownership threshold is 10 percent. Furthermore, firms of all sizes are included in the database for Hungary and Slovenia (as in Estonia, the data for Slovakia include only firms with more than 20 employees). As most of the foreign subsidiaries in mature transition economies like Estonia or Hungary are majority-owned by foreign investors and because foreign subsidiaries are usually larger than domestic firms, the Estonian coverage does effectively not diverge significantly from the other countries.

The importance of foreign-owned firms is obviously not uniform across manufacturing industries. Industries where foreign-owned firms account for more than 50 percent of sales and exports include textiles, leather, motor vehicles and transport equipment. But on top of the list are the paper industry, other non-metallic minerals, and electronics – sectors where foreign-owned firms account for more than three-quarters of exports.

There have also been some noteworthy changes in the importance of foreign-owned firms within the manufacturing sector. Two periods can be distinguished. In 1996-99, leather and leather processing, furniture, wood, and wood processing industries saw the fastest rise in the share of foreign-owned firms in sales and exports. A growing importance of foreign firms also took place in non-metallic minerals and electrical and optical equipment. By contrast, the relative importance of foreign-owned firms declined in sectors such as rubber and plastic. As a result of these changes, the role of foreign firms in economic activity became more concentrated. In 1999-2001, foreign firms became stronger in the electrical and office machinery industry (mainly producing components for mobile phones). Three greenfield investments in this industry gave a boost to high-tech sectors, fundamentally changing the export structure of the country.

Apart from strengthening host countries' export potential, FDI is also expected to enhance their productivity. In Estonia, the productivity gap between foreign and indigenous firms is substantial. In some industries, productivity in the foreign-owned sector is twice as high as in the indigenous sector. To some extent this is because indigenous firms apply labour-intensive technology, while foreign are more capital intensive. Privatisation-driven acquisitions never accounted for the bulk of FDI inflows, suggesting that most FDI has financed gross fixed capital formation. Together with the observation that foreign-owned firms are on average more capital intensive, this indicates that FDI has contributed directly to output and labour productivity growth through higher fixed investment. On average, FDI is estimated to have accounted for some 20 percent of gross fixed capital formation.

*Evidence for Estonia suggests that FDI has contributed to output and labour productivity growth through higher fixed investment.*

That said, it is worth noting that the productivity gap has narrowed in Estonia since 1996 and is among the smallest in CEE countries. An increasing capital intensity of indigenous companies has probably contributed a good deal to the declining productivity gap.

One reason why the productivity gap between foreign and indigenous firms is lower in Estonia than in other CEE economies is that FDI in Estonia has concentrated on labour-intensive, low-tech industries rather than capital-intensive, high-tech ones. But in labour-intensive, low-tech industries the scope for differences in technology and, thus, productivity between foreign and indigenous firms is small. Another reason why the productivity gap between foreign and indigenous firms is lower (and falling) in Estonia than in other CEE economies is the generally lower level of foreign penetration in Estonia. This leaves a considerable part of each manufacturing industry in domestic hands, which fosters cooperation among indigenous firms, thereby spurring their growth more than in a country like Hungary where several industries are almost totally controlled by foreign investors.

But what can we say about the productivity spillovers that are hoped to derive from FDI? Using 1994-98 panel data that cover almost all firms in Slovenia and Estonia,

Damijan *et al.* (2001) test for intra-industry spillovers resulting from FDI. Controlling for potential selection bias in foreign investment decisions, common economic policy influences, and industry effects, the authors show that technology is transferred through the parent-affiliate relationship and intra-company trade, but that the expected spillovers to purely indigenous enterprises rarely materialise.

## 5. Concluding remarks and outlook

In summarising the key features of FDI in the Baltic countries, five points are worth highlighting. First, decisive and early steps in creating a free-market economy, successful macroeconomic stabilisation, and the prospect of EU accession combined to create an investor-friendly environment that attracted foreign direct investment to the Baltic countries.

Second, like small countries in general, Baltic countries attracted mainly investments from neighbouring countries, with some outward FDI from Estonia going to Latvia and Lithuania. There is a more or less outspoken policy that tries to prevent the inflow of Russian direct investment capital.

Third, most of the FDI is in the service sectors, notably banking and transport. Manufacturing FDI went mainly into low-tech industries. FDI has reinforced the given economic structure and has not generated much structural change. In this respect, the Baltic countries, notably Latvia and Lithuania, are more similar to other less developed transition countries like Romania than to the more advanced new EU members. Lithuania with its export-oriented FDI in the textile and clothing industry corresponds most to the pattern of a low-wage transition country.

Fourth, Estonia started first and most radically with liberalisation and privatisation and, thus, benefited from first-mover FDI in the region. It has become a regional centre for foreign affiliates. This environment was also beneficial for indigenous firms, and the productivity gap between them and foreign-owned firms seems to be smaller than in other new EU members from CEE.

Finally, Estonia is more exposed than the other two countries to the behaviour of export-oriented transnational corporations. As a result, Estonia has been much more affected by the recent economic downturn. Especially the slump in the electronics industry caused a slowdown of economic growth, exports, and FDI in 2002. This makes this country more similar to Hungary than to the other Baltic countries.

Reviewing FDI policies, it is, first, useful to stress that the Baltic countries' attitude towards FDI is on the whole liberal. In the mid-1990s, governments began to phase out direct incentives to channel FDI into the economy. Advantages of such incentives did not materialise, and EU accession made the introduction of equal treatment necessary. In line with EU rules, investment support is granted in the context of regional development, SME, and labour market policy objectives.

Second, Latvia and Lithuania have free trade zones, also functioning as export processing zones. Incentives try to attract larger manufacturing investments with some success

*Swift progress with the transition from plan to market spurred FDI inflows, which have, however, preserved rather than changed the structure of the Baltic economies.*

to these zones. With modified legislation, the zones are allowed to live on under EU membership as a regional policy instrument.

Finally, competition between countries for new investments prompted the reduction of the standard corporate tax rates in recent years. Tax competition can be detrimental as it drains funds for public investment and government services. All three Baltic states use similar arguments to attract FDI and appear mostly as competitors to each other. They have done little to coordinate their strategies. The standard advantages they list include the availability of low-cost skilled labour, good geographical location, and political stability. Recently, however, Estonia has been trying to distinguish itself from others by developing the image of an innovative country.

Taking into account the characteristics of the Baltic countries, their FDI policies, and the type of FDI they have attracted so far, what is the outlook for FDI in the years to come? Good prospects for economic growth, pegged currencies, and EU membership are the basic features setting an attractive environment for further FDI. At the same time, the small size of their economies is an impediment to market-seeking FDI. That said, Estonia should be in a position to attract further export-oriented subsidiaries in high-tech industries, while Latvia and Lithuania can use their advantage as low-wage countries to attract export-oriented subsidiaries in low- and medium-tech industries. Finding the specific production and market segments where local competence is of value will increasingly shape the future of FDI in Baltics. These can further strengthen the services functions as well as manufacturing for the regional market.

There is also room for the Baltic countries to further expand their transit role between other EU countries and Russia. Improved political relations with Russia and a more welcoming attitude towards Russian investments could help strengthen this role.

To conclude, the Baltic countries should continue to absorb a fair amount of international FDI flows. But prospects are probably not the same for all countries. Estonia has a clear leading position as to the amount of FDI in the region. It has also a quality and competence advantage, and it started to function as headquarter for foreign investors venturing into the other two countries. For the time being, the other two countries cannot challenge Estonia's role and, thus, FDI flows to Latvia and Lithuania are unlikely to rival those to Estonia.

*Good prospects for economic growth, sound macroeconomic policies, and EU membership should continue to provide an attractive environment for FDI.*

## Annex

**Table A.1 FDI inflows (in USD mn) and type of FDI inflow (in % total inflow)**

	Total inflow (USD mn)	Equity capital (% of total)	Reinvested earnings (% of total)	Inter-company loans (% of total)
<b>Estonia</b>				
1995	201.5	50.3	7.6	42.1
1996	150.2	12.0	12.0	76.0
1997	266.2	36.4	35.6	28.0
1998	580.5	71.0	4.4	24.6
1999	305.1	57.1	15.5	27.4
2000	386.9	58.7	27.3	14.0
2001	542.4	38.8	41.3	19.9
2002	284.6	16.2	72.2	11.6
<b>Latvia</b>				
1996	381.7	57.4	9.1	33.5
1997	521.1	68.4	10.1	21.5
1998	356.7	58.6	16.8	24.6
1999	347.5	51.3	25.7	23.0
2000	410.1	52.1	13.8	34.1
2001	164.0	120.5	36.2	-56.7
2002	396.0	64.7	23.7	11.6
<b>Lithuania</b>				
1995	72.6	90.1	9.9	.
1996	152.4	83.9	16.1	.
1997	354.5	61.4	12.2	26.4
1998	925.5	83.4	10.8	5.8
1999	486.5	76.4	30.1	-6.5
2000	378.9	47.9	23.3	28.8
2001	445.9	58.4	19.2	22.3
2002	732.0	69.0	9.5	21.5

Source: National banks of respective countries (balance of payments data).

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