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**Article**

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## The outward Foreign Direct Investment from the Baltic States<sup>\*</sup>

*Kaarel Kilvits, Alari Purju<sup>\*\*</sup>*

*The article examines the role of foreign direct investment (FDI) in a transition economy. The analysis of structure and dynamics of FDI into Estonia and outflow of FDI from the country demonstrates the important role of the FDI in capital formation of companies. The reason of Estonian firms being important foreign investors in Latvia and Lithuania is mostly geographical closeness of Estonia to Finnish and Swedish capital. The final goal of Finnish and Swedish firms is not to operate only in Estonia, but to move forward to the other Baltic States. A case study of an Estonian enterprise from the food manufacturing industry is presented. The main problems for successful investment abroad have been the difference in business culture and the long distance for operative management of the company.*

*Der Artikel untersucht die Rolle von FDI in Transitionsmärkten. Die Analyse der Struktur und Dynamik der FDI in und aus Estland demonstrieren die wichtige Rolle von FDI bei der Kapitalbildung von Unternehmen. Die Ursache, dass estländische Firmen wichtige Fremdinvestoren in Lettland und Litauen sind, liegt in der geographischen Nähe von Estland zu finnischem und schwedischem Kapital. Der Schwerpunkt der schwedischen und finnischen Firmen liegt nicht alleine auf Estland, sondern auch in den anderen baltischen Staaten. Anhand einer Fallstudie von einem estnischen Unternehmen der Lebensmittelbranche wird die Problematik dargelegt. Die Hauptprobleme für erfolgreiche Investitionen im Ausland waren bisher die Unterschiede in der Unternehmenskultur und die langen Entfernungen für das operative Management des Unternehmens.*

*Key words: Outward FDI / Baltic States / business culture / banking sector / food industry*

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## **1. Introduction**

After the upheaval in Central and Eastern Europe (CEE), massive investments are needed to modernise all aspects of the economy to raise productivity. Transition economies have in general low levels of domestic savings due to their low levels of incomes. Foreign direct investment is an important contribution to the process of restructuring, economic growth and development of technology in the transition economies. Estonia has been one of the most successful transition countries of CEE in attracting FDI on a per capita basis.

Estonia liberalised its capital movements further than required by its Europe Agreement. Foreign investors may open accounts in both foreign and domestic currency. Profits and enterprise liquidation income can be freely repatriated, and the currency is fully convertible. Due to its very liberal economic policy, closeness to Finland and Sweden (Finnish and Swedish capital), success in attracting FDI and relatively fast economic development Estonia has become also a source of direct investment to other countries (mainly to other Baltic countries).

## **2. Comparison of Estonian FDI with Other Countries**

International studies show that acquiring new markets and increasing sales have been the main motivation for making FDI. The development in East Europe (in post-socialist countries) has been no different. Apart from the sales motive, cost factors also play an important part in FDI decisions. In Eastern Europe, a favourable cost factor has most often been the low labour cost. In addition to market considerations, both strategic position factors (to gain first mover advantages and/or to follow customers/competitors) and investment climate factors have played very important roles in the FDI decision-making process (Hirvensalo & Hazley, 1998; Mayer, 1998; Ziatic, 2000).

Earlier the differences in factor endowments (i.e. cost of labour, availability of natural resources) were among the most decisive factors in explaining the location of FDI in the target countries. However, the significance of these factors has declined during the last decades and other factors have gained importance. For example, the institutional framework has increased in importance (Tahir, 2000).

Foreign direct investors may also obtain an effective voice in the management of another business entity through means other than acquiring an equity stake. These are non-equity forms of FDI, and they include subcontracting, management contracts, franchising, licensing and product sharing. Data of transnational corporate activity through these forms are usually not separately identified in balance-of-payments statistics. These statistics, however, usually present data on royalties and licensing fees, defined as receipts and payments of residents and non-residents for: (1) the authorised use of intangible non-

produced, non-financial assets and proprietary rights such as trademarks, copyrights, patents, processes, techniques, designs, manufacturing rights, franchises, etc.; and (2) the use, through licensing agreements, of produced originals or prototypes, such as manuscripts and films.

According to the UN (2000), in 1999 FDI inflows in world were USD 865.5 billion, from this in Central and Eastern Europe USD 21.4 billion or 2.5%. Inward FDI flows as percentage of gross fixed capital formation in 1998 were, according to the UN statistics, in the world 11%, in Central and Eastern Europe 13%, in Estonia 38%, in Latvia 28%, and in Lithuania 35%.

At the end of 2000, foreign investments made into Estonia formed 90864 million kroons. Of the foreign investments made into Estonia 49% were direct investments (44495 million kroons). A significant part of direct investments came from Sweden (41%) and Finland (30%). Other most important investor countries were Norway (4.3%), the USA (4.2), Denmark (4.0%), Germany (2.6%), the UK (2.4%), the Netherlands (2.2%), Liechtenstein (1.5%), Russia (1.2%), Switzerland (1.1%), Singapore (1.0%), Italy (0.7%), Ireland (0.4%), Austria (0.3%), and Latvia (0.2%) (<http://www.ee/epbe/fdi/4b/html.en>).

The most attractive sectors for foreign direct investors in Estonia were finance (25%), transport, storage and communication (22%), manufacturing (22%), wholesale and retail trade (16%), real estate, renting and business activities (7%), electricity, gas and water supply (2%), hotels and restaurants (2%), construction (2%), agriculture, hunting and forestry (1%), and other community, social and personal service activities (1%).

Outward FDI flows as percentage of gross fixed capital formation in 1998 were, according to the UN statistics, in the world 12% (sums of inflows and outflows are not absolutely equal by the UN statistics), in Central and Eastern Europe 1.4%, in Estonia 0.4%, in Latvia 4.2%, and in Lithuania 0.2% (UN, 2000).

### **3. Estonian Direct Investments Abroad**

Internalisation of Estonian firms was accomplished in the early 1990s primarily using direct and indirect exports. As late as in 1996 Estonian firms started really to use investment as a foreign market entry method. It was followed by the first significant outflow boom year of 1997 with outward FDI totalling EEK 1912.9 million. At that time, Estonia was factually the leading outward investing transition economy with regard to per capita flows. In 1998, a heavy fluctuation and stagnation of outward FDI followed. High volatility of FDI outflows appears to be characteristic as the total stock of FDI abroad is very limited. Even a single operation reducing investments abroad causes significant changes in outflows (see Table 1).

*Table 1. Foreign Direct Investments 1993-2000 (billion Estonian kroons)*

<b>Year</b>	<b>FDI (net)</b>	<b>Inflow</b>	<b>Outflow</b>
1993	2.071	2.153	-0.082
1994	2.789	2.819	-0.030
1995	2.282	2.313	0.029
1996	1.330	1.814	-0.484
1997	1.781	3.694	-1.913
1998	7.990	8.071	-0.081
1999	3.208	4.448	-1.240
2000	4.141	6.807	-2.666

Source: <http://www.ee/epbe/makromajandus>

The majority of Estonian investments abroad were made into real estate, rent and business services and the finance. More than two thirds of investments were made into Latvia and Lithuania. The increase of direct investments abroad resulted, on the one hand, from the strengthening of the economic positions of Estonian companies. On the other hand, this rapid development can also be attributed to the improved access to local and foreign credit resources. This conclusion is supported by the fact that when access to credit resources became more limited in 1998 and in the first half of 1999 and Estonia's economic situation deteriorated, direct investments from Estonia abroad fell sharply (see Table 2).

*Table 2. Direct Investment Stock from Estonia to Other Countries by Fields of Activity (31.12.2000)*

	Million kroons	%
Finance	4517.8	60.6
Real estate, renting and business activities	1072.6	14.4
Transport, storage and communication	770.9	10.3
Manufacturing	658.3	8.8
Wholesale, retail trade	346.4	4.6
Construction	32.9	0.4
Other	50.1	0.9
TOTAL	7449.0	100.0

Source: <http://www.ee/epbe/fdi>

After the Russian crisis in late 1998 the direct investment outflows were replaced by the process of taking back loans from affiliates of Estonian firms abroad. Outflows into the transport, storage and communication sector were drastically reversed, and the economic turbulence of 1998 led to further reversals and losses in total outward direct investment. Operating losses and loan repayments reduced outward investment especially into industry, transport,

storage and communication, while banking losses and consolidation affected the financial sector. In consequence, the withdrawal of outward investments, including portfolio investments, raised net capital flows into Estonia. Most of the investments abroad were in finance, real estate, leasing and business services, and trade.

In 2000, Estonian direct investors placed capital into Latvian finance, real estate, rent, and business services sector as well as into wholesale and retail trade businesses. Investing into affiliated companies abroad remained active. Half of the direct investment outflow consisted of investments into share capital and the other half was loans. The biggest increase was recorded in long-term loan capital claims (see Table 3).

*Table 3. Direct Investments from Estonia to Other Countries (31.12.2000)*

	Million kroons	%
Latvia	3994.2	53.6
Lithuania	2329.2	31.3
Cyprus	605.6	8.1
Ukraine	94.6	1.3
Russia	42.4	0.6
The Bahamas	24.9	0.3
Poland	15.6	0.2
Other	345.2	4.6
TOTAL	7449.0	100.0

Source: <http://www.ee/epbe/fdi>

The most important part of these capital flows was related to strategic investments made into other Baltic States by banks and other financial intermediaries. On the ground of that information the following conclusions can be drawn:

- The FDI outward stock at the end 2000 was 17% of the FDI inward stock (7449.0 and 44495.1 million kroons respectively). We can conclude that Estonian FDI abroad were less successful than FDI made in Estonia (losses in Russia, etc.).
- The FDI inflows per capita were 5568 kroons in 1998, 3084 kroons in 1999 and 4730 kroons in 2000. The FDI outflows per capita were 860 kroons in 1999 and 1853 kroons in 2000.
- The FDI inflows as percentage of investment in fixed assets was 35% in 2000, while the FDI outflows as percentage of investment in fixed assets was 14%.
- The FDI inward stock as percentage of GDP at current prices is more than 50%, the FDI outward stock as percentage of GDP at current prices was 9% at the end of 2000.

The stability of outward direct investments is questionable due to their concentration in the volatile Baltic financial sector. Outflows have mainly resulted from the expansion of Estonian commercial banks, financial services and insurance companies (belonging mostly to Swedish capital) into the Latvian and Lithuanian markets. At the end of 2000, 61% of the Estonian outward direct investment stock had been invested in the financial sector, with other sectors following far behind: real estate, renting and business activities 14%, transport, storage and communication 10%, manufacturing 9%, and wholesale and retail trade 5%.

The major group of outward investments is deriving from the banking sector, which indicates that the domestic market is becoming too small for Estonian commercial banks and they are entering neighbouring Baltic markets. The major investors were *Hansapank* and *Ühispank*, two biggest commercial banks in the Baltic States, which bought several Latvian and Lithuanian small commercial banks. This also explains why the largest part of total outward FDI of Estonian firms was made in the form of loan capital. The proportion of share capital and reinvested earnings was only 7%.

Estonian manufacturing companies have not used widely outward investments as a foreign market entry method, which have mainly been limited to small investments in the food processing industry.

Direct investment outflows appear uncharacteristically volatile. This is due to the low absolute level of outward direct investment, which results in a single major operation swelling the aggregate figure. Although high in per capita terms, Estonian direct investments are actually not important in total FDI inflows into Latvia, its main recipient in 1993-2000.

Many data recordings can actually be traced back to individual purchases: a meat plant acquired the largest meatpacking plant in Latvia. An Estonian based textile, paper and property business extended its operations to Latvia and Lithuania. The Tallinn Dairy acquired a milk-processing plant in Ukraine, and Tallinn's largest department store opened an unsuccessful branch in Helsinki.

In 2000, Estonia was the economic leader of the Baltic States. However, the future is not clear. Latvia has the central geographical position in the Baltic States. Riga is potentially the 'capital of the Baltic States'. Latvian and Lithuanian markets are larger than the Estonian market.

The Baltic States cannot offer a large and affluent internal market for foreign investors. The Baltic sub-region has a market of only some 8 million inhabitants. The Baltic States can geographically offer a bridgehead position to foreign firms interested in the Russian and other CIS markets (Tiusanen & Jumpponen, 2000).

There is an obvious competition between Tallinn in Estonia and Riga in Latvia in the race to acquire the reputation of being the 'hub' of business life in the Baltic region. Vilnius in Lithuania seems to be out of the race. Both Lithuanian

main cities, Vilnius and Kaunas, are land-locked, while Tallinn and Riga have their harbours (Tiusanen & Talvitie, 1998).

## **4. Direct Investments from Estonia to Main Host Countries**

### **4.1. Latvia**

Latvia has a general policy of foreign investment, and appropriate legal acts have been passed to maintain this. The basic principle of this policy is to facilitate the flow of foreign capital into those areas of the Latvian economy which require high levels of capital investment or complete or partial modernisation of equipment, or into those areas which are poorly developed but which could develop Latvia's export base. The foreign investment policy sets down certain criteria under which the usefulness of foreign capital offers is evaluated (*Conditions for...*, 1996):

- The impact of the investment on the Latvian economy, especially where the following areas are concerned: job creation, the use of local raw materials, resources and services, export of Latvian goods.
- The impact of the investment on productivity, development of technology, improvement of production quality and broadening of the range of produced goods.
- The impact of the investment on competition in the proposed area.
- Possible domination by certain countries in the Latvian economy.
- The impact of investment on the competitiveness of Latvian goods on the world market.
- The impact of investment on the environment.

Problems for investors in Latvia were the following: selection of companies to be privatised; the privatisation process itself; the use of privatisation certificates; the unresolved questions of land ownership; the treatment of enterprise liabilities. Serious problems for foreign investors in Latvia are related to acquisition of information about new legislative acts. Court cases take a very long time to be tried (Spica, 1999). Product certification and registration is difficult (Hirvensalo & Hazley, 1998).

According to the Bank of Estonia, Estonia had direct investments worth EEK 3994.2 million in Latvia at the end of 2000 (54% of all direct investments abroad). According to the Latvian statistics, Estonia was the sixth biggest investor country in Latvia (5%), after Denmark (14%), the USA (10%), Sweden (8%), Russia (7%), and the UK (7%). Estonia was followed by Finland (5%) and Norway (4%).

## 4.2. Lithuania

Lithuania's record in attracting foreign capital is not especially impressive. This is true despite a relatively successful privatisation programme. Lithuania has shown a rather nationalistic attitude when it comes to asset sales to foreigners.

The criticism voiced by foreign investors in Lithuania is mostly about the state's heavy-handed approach towards business (Spica, 1999). Companies had experienced problems due to either the complicated nature of procedures or the protectionist policies of the government. Legislative environment apparently restricts foreign investments at both establishment and operation levels (Hirvensalo & Hazley, 1998).

According to the Bank of Estonia, Estonia had direct investments worth EEK 2329.2 million in Lithuania at the end of 2000 (31% of all direct investments abroad). According to the Lithuanian Central Bank, Estonia had FDI in Lithuania worth LTL 629.77 million (<http://www.lbank.lt/Eng/publications/PDF/mb002/35.pdf>). This was 7% of all FDI in Lithuania at the end of June 2000. Estonia was the fifth biggest investor country in Lithuania, after Sweden (18%), the USA (13%), Finland (10%), and Denmark (10%). Estonia was followed by the United Kingdom (7%), Germany (7%), Switzerland (6%), Norway (4%), and Luxembourg (3%).

## 5. Some Examples on the Company Level

As 85% of Estonian investments abroad have been made in the other Baltic States (Latvia 54% and Lithuania 31%) and 61% of Estonian investments abroad are connected with financial sector, it is possible to conclude that the main direct investors abroad are *Hansapank* and *Ühispank* in Latvia and Lithuania. The rest of the investors and target countries are represented very modestly, like for example:

- *Ober-Haus* (real estate company) signed on 5 January 2001 a contract for the management of a shopping centre and a movie house in Gdynsk, Poland. *Ober-Haus* has 14 offices in Estonia, Latvia, Lithuania and Poland.
- *AS A. Le Coq*, the subsidiary of the Finnish beverage group *Olvi OY*, increased on 27 November 2000 its holding in the Lithuanian brewery *Raguta* to 50%.

In the following, a case of less successful internationalisation story is provided i.e. the internationalisation attempt of an Estonian company, *Ösel Foods*, is described.

## 5.1. A Case: Ösel Foods<sup>1</sup>

### 5.1.1. General Description

Ösel Foods AS was established in Saaremaa, an Estonian island in the Baltic Sea, in 1993. Today, it belongs to three persons. Two citizens of Estonia have 50% of the shares and a Finnish citizen owns another 50% of the shares. The two Estonian owners bought up wild berries and consigned cranberries to *Marli* factory in Finland. In return, they got the juice concentrate Mehukatti, which was sold in Estonia. They bought equipment from Sweden, rented rooms from Saaremaa meat and dairy factory and started to manufacture the concentrate.

As the company was not able to satisfy the demand for Mehukatti, in November 1993 a manufacturing complex was established in Reola, near the Estonian second largest town Tartu. In Reola the production complex is situated in the previous large farm of the Estonian Agricultural Academy. Ösel Foods AS invested 12 million kroons into manufacturing.

In January 1999, Ösel Foods AS bought from a Norwegian company a fishing manufactory in Paljassaare, an area of the Estonian capital Tallinn. One reason for selling the manufactory to Ösel Foods AS was that they had access to Russian sale channels that could be used also for trading with fish. The fishing unit was in a bad shape due to the Russian financial crisis of August 1998 and the loan from Hansapank together with Ösel Foods AS own investment was regarded as a sufficient condition to vitalise the fishing manufacture.

At the beginning of 2000, the parent company Ösel Foods AS announced the press that their new board planned to make several changes in the structure of the company and to take it to the stock exchange. With the intention to increase capitalisation of the company and making it public, there was also a need to make it more open and transparent to attract new owners. The idea was to create a holding company with different subunits, such as *Ösel Esva AS*, which cans fish. Ösel Foods AS continues with soft drinks, *Ösel Mari AS* deals with berries and *Ösel Invest AS* holds investments in Russia.

### 5.1.2. Foreign Direct Investment Abroad

Export to Russia was considered as an important strategy for the company because Russian big cities Moscow and St. Petersburg demonstrated high demand for Estonian food products. At the same time, there were specific conditions for exports. The cap between wholesale and retail sale prices was several times larger than in Estonia due to larger numbers of intermediates causing very high retail prices. A picture was created that everything was very

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<sup>1</sup> The contribution of Evelin Aarma is acknowledged in preparation of the case study on Ösel Food.

expensive and it was possible to earn a large amount of money. Wholesale prices were low and the exporter had to base on the economy of scale. All leading producers of the world were represented and on the ketchup of Ösel Foods AS had to compete on the market with more than 200 other similar products. High competition led to a situation that for market entry products had to be sold on credit. This created for Estonian companies heavy losses after the 1998 financial crisis in Russia.

A big obstacle has been created by the customs tariffs system. In May 1996, the Russian Customs Committee initiated a new regulation according to which customs tariffs were calculated on the basis of the quantity of goods, not price as previously. As Estonia did not have a Most Favoured Nation (MFN) regime with Russia, the Estonian exporters met double tariffs compared with exporters from countries having the MFN agreement. The tariffs constituted up to 40% of the price of soft drink and up to 35% of the price of ketchup. Another major source of problems has been high transportation costs, which constitute up to 30% of the price of soft drinks. On the other hand, the relatively high inflation in Russia and rouble, which was fixed to the US dollar, created macroeconomic conditions where real effective foreign exchange rate of kroon against the rouble depreciated and supported Estonian exporters.

The importance of Russian exports increased substantially in 1997. Avoiding of customs tariffs and diminishing transportation costs, Ösel Foods AS decided to establish a production unit in Moscow. The idea was to create a good basis for manufacturing and starting with ketchup and mayonnaise to move further with juice concentrates and fish processing. A joint venture with the Russian wholesale company *Mir 93* was founded in 1997. The share capital of the joint venture with name Ösel Invest AS was USD 1 million of which Ösel Foods AS put into company about 60%. A suitable place was found around 20 km from the central area of Moscow. The rent agreement for the use of 2400 square metres land and facilities was signed with local authorities for 20 years. The hire of 100 local people was planned.

In February 1998, the construction company finished rebuilding an old dining place of a Soviet time manufacturing plant. The equipment for the unit was brought from Estonia. Only a small part of the equipment was bought for share capital additionally. All costs related to the new unit in Moscow amounted to 21 million kroons, 8 million kroons for construction and 13 million kroons for equipment. The output was planned at a level of 1000 tons per month. At that scale of production, the investment costs would be covered during two years.

The start of production was postponed several times due to various reasons. First, there were problems with getting equipment into Russia from Estonia tax-free. Then problems with installation and training emerged. After that getting production allowances and certificates from Russian respective services was

postponed several times. In August 1998, the company was ready to start production in Russia.

The joint venture in Moscow started operation in a few weeks after the financial crisis. The relatively costly imported inputs created losses after the decline of Russian prices in USD terms after deep devaluation of the rouble. In October 1998, the company was using only 25% of its capacities for the production of ketchup. At the same time, the company introduced production of plastic bottles in Moscow. The company made a contract with the *Baltimor* company in St. Petersburg for 1 million bottles per month. Most of the revenue during 1999 came from the production of plastic bottles. The respective equipment worked 24 hours per day. Nevertheless, due to the decline of exports and low production in Russia, Õsel Foods AS made heavy losses in 1999. At the same time, as the company reinvested profits and used a limited amount of bank credits, consolidation was possible in 2000.

The company met the following challenges: (1) to create a large enterprise with a turnover of a billion kroons and emerge with substantial market share after two to three years; (2) to consolidate the factory and sell it then to some global company in the same field; and (3) to accept losses and to think about market exit. The main problems, according to managers of the company, have been the difference in business culture and the distance of 1000 km, which is too long for operative management of the company. The management of joint venture was taken over by Russian partners in 2000. Today, the company in Moscow is in sale and Õsel Foods AS expects to get some compensation for assets.

## 6. Conclusions

Although the volume of FDI is quite low on global scale, Estonia is one the most successful transition countries of CEE attracting FDI on a per capita basis. Due to liberal economic policy, closeness to Finland and Sweden (Finnish and Swedish capital), success in attracting FDI and relatively fast economic development Estonia has also become a local (mainly Baltic) direct investor abroad. Though Estonian firms are important foreign investors in Latvia and Lithuania, the real reason of such situation is mostly geographical closeness of Estonia to Finnish and Swedish capital. The final goal of Finnish and Swedish firms is not to operate only in Estonia, but to move forward to the south. Estonia is simply the first step of Baltic stairs.

It is easier for Estonian businessmen and administrators (managers) to operate in Latvia and Lithuania than for Finnish and Swedish people. Estonians know the local economic environment and have personal level contacts. Estonian top managers are engaged by Finnish and Swedish capital.

Estonian investors meet (psychological) resistance in Latvia and Lithuania. Some persons tend to think: we were together in the Soviet Union and now you

are buying our firms. However, this resistance is decreasing. The main reasons for this are: (1) the number of firms belonging only to Estonian capital is decreasing; and (2) most Estonian investors have engaged local top managers.

Economically, Estonia does not act in the Baltic region as a pioneer. FDI from Estonia to Latvia and Lithuania are actually mostly West (Finnish, Swedish) capital going through Estonia. Estonia is a connecting link and firms registered in Estonia function as the temporary agents.

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