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Jorge Durán  
and Héctor Navarrete-Plana

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## FDI and Investment Uncertainty in the Baltics

By Jorge Durán and Héctor Navarrete-Plana

### Summary

Foreign direct investment (FDI) flows into the Baltic states collapsed during the crisis, experienced a short-lived recovery, and then plunged again. Today it remains subdued despite a modest but sustained recovery. This is worrying because FDI is a channel for technology transfers and its shortfall could imply that the Baltic states risk falling into a ‘middle income trap’ at around 70% of the EU-15 average income. This paper argues that the slow recovery of FDI is rather due to poor international market conditions, holding back investment in general and FDI in particular. Accordingly, FDI is expected to pick up once the economic environment improves. Still, further improving the framework conditions for investment could help to attract and reap the benefits of FDI in the future, particularly in Latvia and Lithuania.

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**Contact:** Jorge Durán, European Commission, Directorate-General for Economic and Financial Affairs, Unit E2 - Estonia, Latvia, Lithuania, Netherlands, email: [jorge.duran-laguna@ec.europa.eu](mailto:jorge.duran-laguna@ec.europa.eu); and Héctor Navarrete-Plana, Moody's Investors Service.

## Introduction

Before the crisis of 2008-2010, the Baltic states were catching-up rapidly with the EU average. Investment was largely funded abroad and took mostly the form of foreign direct investment (FDI). The balance of FDI flows<sup>1</sup> was around 5% of GDP on average over the period 1995-2007 (Graph 1). However, the crisis severely hit the Baltic economies: both economic activity and employment contracted between 10 and 20 pps., far more than the 5 pps. average for the EU (Graph 2). While the downturn was deep, the economy rebounded swiftly only to slow down again around 2011-2012. Since then, investment has stalled in Lithuania and contracted again in Estonia and Latvia. **FDI has collapsed** and remains subdued despite the modest but **sustained recovery** of GDP.

The low levels of FDI flows could indicate a worrying trend because FDI is known to play an important role in the adoption and development of new technologies, at least while these economies remain far from the technological frontier.<sup>2</sup> Several explanations for the slowdown in FDI have been put forward, including general uncertainty about business conditions,<sup>3</sup> labour costs, sanctions to Russia, or structural problems—the so-called middle-income trap.<sup>4</sup>

This paper reviews the basic figures, explores trends and recent developments, and discusses possible reasons for the low levels of FDI. It argues that the main reason is the **uncertain economic**

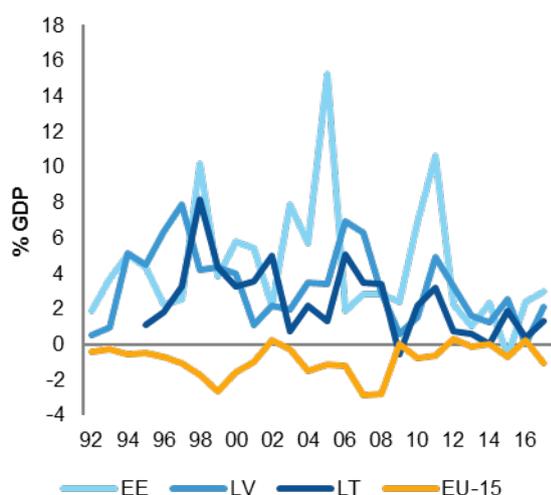
**environment** both domestically and internationally. Once economic prospects improve, clearing uncertainty about the economy, FDI should recover.

It may not return to the levels of the past because massive privatisations are over and some sectors—notably banking—have already been taken over by foreign capital but given the distance to the technological frontier, there has to be room for future foreign investments. Taking a longer time perspective **institutional conditions** could improve to attract more foreign investment and dispel the risk of a middle-income trap. Latvia and Lithuania have room to get closer to Estonia, the best performer in the region at attracting FDI and in international comparisons of institutional quality.

## Transition and catching-up

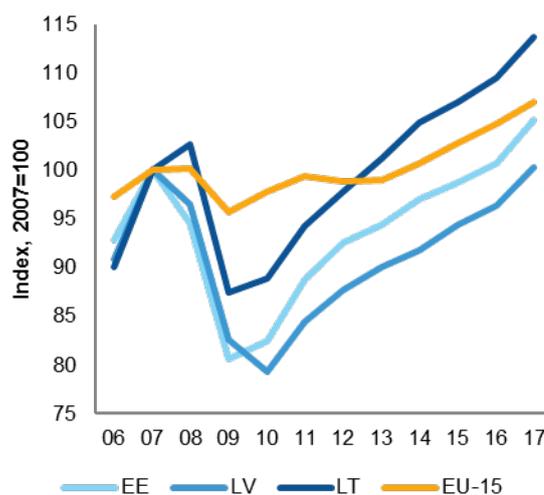
After the collapse of the Soviet economy, income per head in the Baltic states was barely 30% of the average of the EU-15 (in purchasing power standards, PPS). The Baltic states had low income but relatively good education and institutions, political stability, and a credible monetary policy committed to low, stable inflation and the goal of joining the euro area. With these ingredients, the transition to a market economy led to a remarkable take-off and before the crisis hit, income was already between 53% and 60% of the average of the EU-15.

Graph 1. Balance of FDI flows (inflow minus outflow)



Source: UNCTAD

Graph 2. Real GDP

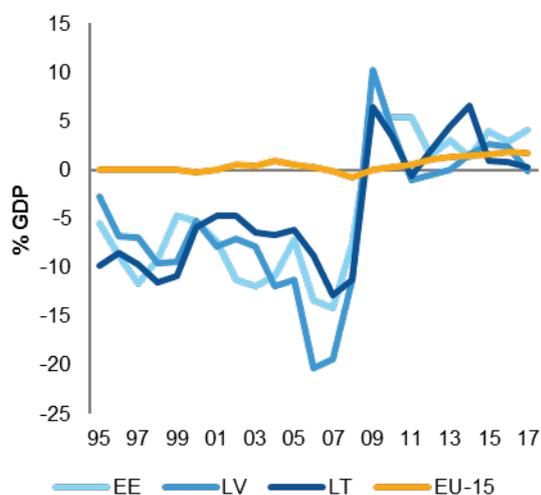


Source: Commission services, AMECO database

## Massive investments

Catching-up relied to a large extent on the opening of the economy with massive investment mostly funded from abroad and fast growing exports. Investment followed improvements in the regulatory environment—laws and regulations were brought in line with EU practices incorporating the *Acquis Communautaire*—and the launch of large privatisation programmes. As a consequence, in the years preceding the crisis, FDI inflows were sizeable reaching a notable annual peak of 23% of GDP in Estonia and 4.7% and 4.3% of GDP in Latvia and Lithuania respectively.

Graph 3. Net lending (+) / borrowing (-) of the economy



Source: Commission services, AMECO database

Discounting outflows, the figure is slightly smaller for Estonia but the comparison with the euro area gives an idea of the magnitude of the flows (see again Graph 1). The opening to foreign investment came along with full integration in international trade: real exports tripled between 1996 and the start of the great recession in 2008.

## Foreign capital and regional integration

During the boom period, investment relied on large **external borrowing**. Over the period 1995-2006, the Baltic economies borrowed abroad every year between five and 10 pps. of GDP and as much as 20 pps. in the case of Latvia in 2006 (Graph 3). Comparing Graph 1 and Graph 3 it is clear that external borrowing largely consisted of FDI. While the three Baltic states were important recipients of foreign investment, their ability to attract it differed substantially: by 2015, Estonia had an inward FDI

stock equivalent to 100% of gross value added (GVA), Latvia 63%, and Lithuania around 40%.

The main sources were neighboring countries and traditional partners with historical ties to the Baltic states (Table 1). Sweden is by far the largest investor. In 2015, the Swedish investment position, reflected in its share of the total FDI stock was 24% in Estonia, 12% in Latvia, and 9.3% in Lithuania. The second largest investor is Finland, with 22% of the stock in Estonia but much less in Latvia and Lithuania. Far behind we find the Netherlands and Germany, both holding a stock between 6% and 9% of GVA.<sup>5</sup> It is noteworthy that Estonia is the only Baltic state that is a large investor in the other two countries.

Russia is also an important investor with 4.6% of the stock in Estonia and 8.8% in Latvia but not in Lithuania where it has a negligible share of the stock. Finally, Cyprus is also an important investor, particularly in Latvia, but most likely because its non-resident banking sector channels what ultimately turns out to be Latvian and Russian investment.<sup>6</sup>

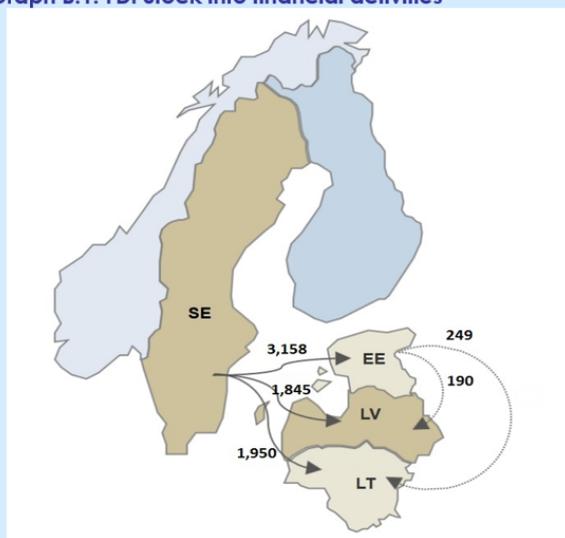
## Sectoral FDI profile

From the sectoral perspective, we can distinguish between investment targeted at domestic supply and investment directed at serving foreign markets by taking advantage of lower production costs (see Table 2). A case in point for **domestic supply FDI** is the banking sector. In the three countries, the financial and insurance sectors are major recipients of FDI (Box 1). In planned economies, some sectors like banking and insurance services or real estate and property management are by definition less developed than in market economies. As a consequence, these sectors attracted foreign capital after the economy opened. In addition, the banks that moved into the Baltics brought with them a competitive reputation for solvency. Either way, the financial sector stands out as the largest beneficiary of FDI. Following accession to the EU in 2004, the inflows to the financial sector rose by a factor of four in Latvia and two in Lithuania. In Estonia, the same sudden and stable rise of inflows occurred a year later. In 2005 they accounted for 51% of the sectoral GVA up from 49% in 2004, a spike due primarily to Swedbank's acquisition of Hansabank. In 2014, the financial sector represented 30% of the FDI stock in Lithuania and 29% in Estonia and Latvia. Second to the financial sector, is the real

### Box 1: Nordics in the Baltics – An overview of the financial sector

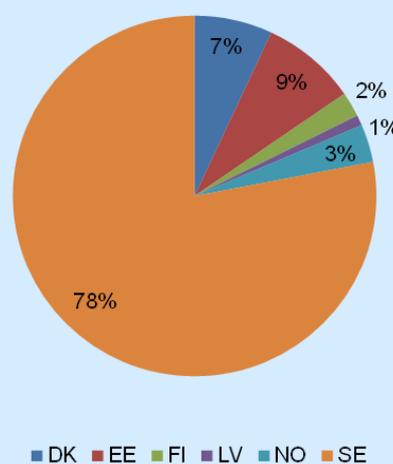
The Nordic countries and in particular Sweden have a significant presence in the Baltics' financial sector. This is illustrated by the importance of the financial sector inward FDI stock of Sweden into the Baltic States, which amounts to EUR 3158 million (18.37% of GDP), EUR 1845 million (8.81%) and EUR 1950 million (5.9%) for Estonia, Latvia and Lithuania respectively (Graph B.1). Swedish banks represent 5 of the major Estonian credit institutions and hold 78% of total banking assets as of December 2016. This position was driven by acquisitions: Swedbank (39% of assets) acquired Hansabank in 2005 and SEB (23% of assets) acquired Eesti Ühispank in 2000. As FDI data suggests, Sweden has a larger position in Estonia's financial sector than in their fellow Baltic States. We also observe that Estonia is a significant investor in Latvia and Lithuania, with Estonia's position representing 20.2% and 37.6% of the respective financial industry.

**Graph B.1. FDI Stock into financial activities**



Source: Eurostat

**Graph B.2. Estonia banking assets by country of origin**



Source: Estonia Financial Supervision

The Latvian financial sector offers an interesting case within the Baltics. Scandinavian banks (again, led by Swedbank and SEB) which rely on cheap funding from their parent firms, took over the domestic credit and deposit market. On the other hand, national firms have specialised in non-resident banking and provide deposits to CIS businesses and individuals. At the end of 2016 non-residents amounted to 43% of total deposits. Since 88% of the non-resident deposits are available on demand, this short term maturity has been seen as liquidity risk threatening the Latvian financial sector.

Following the transition of the Baltics to a market economy, Scandinavian banks seized the opportunity to provide banking services in these countries whilst relying on inexpensive funding from their parents. Some of these credit institutions now dominate domestic markets and look to develop further in these markets. The recent merger between Nordea and DNB Baltic business divisions, the future Luminor, shows the strong presence and continuing interest of Nordics in the Baltics.

estate activities sector, with 17% of the total FDI stock in Estonia and 14% in Latvia and Lithuania.

Sectors that **serve external demand** have also been recipients of FDI, most likely to profit from lower production costs in the Baltics in addition to a certain manufacturing tradition in the region. FDI is large in manufacturing and wholesale and retail trade in all three Baltic States. Manufacturing represented 12% to 13% of the total FDI inflow stock in 2014. Similarly, wholesale and retail trade

represented around 14% in the three economies. These sectors are more outwardly oriented than financial or real estate services, and hence the rise of investment following the transition relates to foreign demand and lower costs, both labour and other fixed costs, such as equipment goods or factories.<sup>7</sup> As such, they are potentially more sensitive to increasing labour costs or weak external demand, an important detail to keep in mind in the discussion below.

Table 1. Inward FDI stock by country of origin, percentage of GVA of the recipient country

	Estonia		Latvia		Lithuania	
	2000	2015	2000	2015	2000	2015
Denmark	0.0	2.2	2.9	2.7	4.1	1.7
Germany	1.3	1.4	2.4	3.3	1.7	3.7
Cyprus	-0.1	3.7	0.0	5.9	0.0	1.4
Latvia	0.1	2.7	:	:	0.3	0.7
Lithuania	-0.1	3.4	0.1	2.7	:	:
Estonia	:	:	2.6	4.2	1.4	2.1
Netherlands	1.3	9.6	0.8	4.8	0.3	5.0
Finland	15.4	22.5	1.8	1.8	1.4	1.7
Sweden	20.5	25.0	3.0	12.2	3.9	9.3
United Kingdom	1.3	2.0	1.5	2.4	1.5	1.2
Norway	2.2	4.0	1.6	3.4	1.0	2.5
Russia	0.6	4.6	1.7	5.5	0.2	0.6
Poland	0.0	0.2	0.0	0.3	0.5	2.1
World	51.6	99.8	28.8	62.8	22.6	40.2

Source: Eurostat

Table 2. Inward FDI stock by sector, percentage of GVA of the sector

	Estonia		Latvia		Lithuania	
	2000	2014	2000	2014	2000	2014
Total	52	99	29	56	23	38
Agriculture, forestry and fishing	7	54	7	72	2	14
Mining and quarrying	19	29	98	97	35	64
Manufacturing	65	76	31	61	34	39
Construction	13	15	3	30	3	12
Wholesale and retail trade	54	116	38	54	31	25
Transportation and storage	112	61	46	23	50	8
Accommodation and food services	64	29	45	37	35	13
Financial and insurance activities	311	748	196	362	178	556
Real estate activities	29	171	24	61	9	84

Source: Eurostat

## Crisis and aftermath

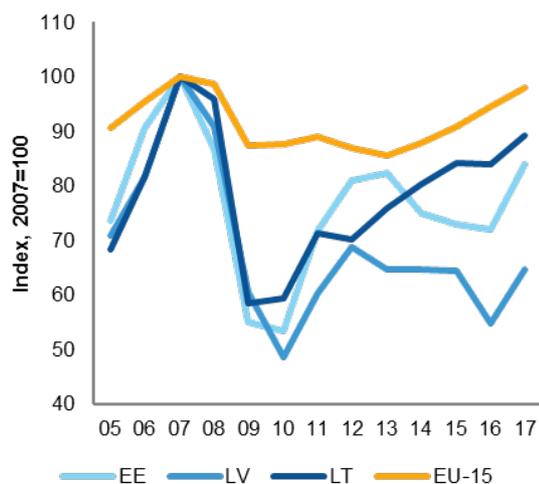
The 2008-2010 recession led to the near collapse of investment, including FDI, still reflected today in a positive net lending position of the economy as a whole (see again Graph 3), a situation atypical for emerging economies.

## Contraction and a protracted recovery

The opening to foreign trade and investment came at the price of leaving the Baltic economies exposed to

the global economic environment and, in particular, to the performance of other EU countries. When the domestic credit bubble burst, compounded by the global recession, these **small, open economies were hit hard** with GDP per head contracting 15% to 20% in 2009-2010 and total employment contracting 20% in Latvia and 15% in Estonia and Lithuania.<sup>8</sup> The contraction of investment was even more pronounced, cut by half between 2007 and 2009 (Graph 4) leading to an unusual positive net lending position with the rest of the world and to the collapse of FDI.

Graph 4. Real gross fixed capital formation per capita



Source: Commission services, AMECO database

Despite the breadth of the downturn, the three economies recovered swiftly and by 2011, real GDP was growing at 5-6% a year. Even though it was dragged down by a wave of emigration, GDP per capita was actually growing at 6-7% per year. Growth eventually slowed down following the second dip recession of the euro area but remained positive. In contrast, investment contracted again as it did elsewhere in the euro area: it stalled in Lithuania and collapsed in Estonia and Latvia. Transport equipment, non-residential investment, and housing investment were particularly affected by the contraction and the subsequent slowdown. Other investment and investment in machines showed more resilience in all three countries while in Lithuania residential investment recovered relatively quickly.

### A collapse of FDI across the board

Similarly to capital formation, the contraction in FDI was sharp but short-lived. Some investor countries even showed some resilience, notably Sweden, which invested over EUR 1 billion in the three Baltic states between 2009 and 2011. But the recovery soon faltered and the second investment dip in 2013-2014 came along with generalised and sometimes sizeable disinvestments.<sup>9</sup> Most sectors were affected by this second crisis. Financial activities, the sector with more cross-border capital flows, showed some resilience but also important disinvestments in certain years. A notable exception to this general contraction was manufacturing in Lithuania, which suffered relatively less during the crisis or the subsequent second dip.

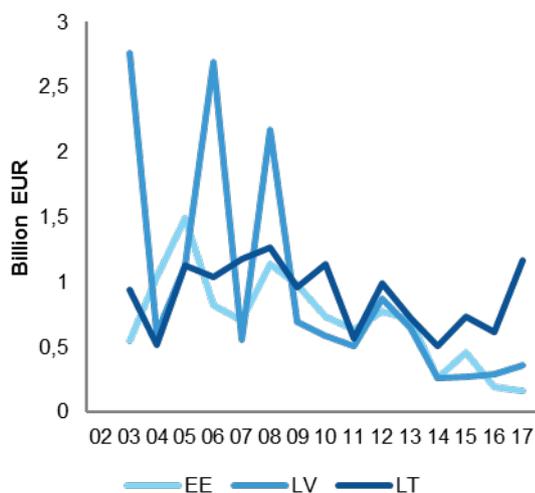
By type, **greenfield FDI** projects suffered the most, with total investment flows falling below EUR 500 million in Estonia and Latvia and only slightly less in Lithuania, to compare with figures between 1 and 1.5 billion before the crisis (Graph 5). A similar pattern can be seen in terms of the number of projects, which dropped from 55 per year on average to less than 20 in Estonia and Latvia. Again, the exception is Lithuania, a country with a strong tradition in manufacturing, where the value of greenfield FDI dropped less and the number of projects actually increased slightly, in line with the observation above concerning inflows into this sector. In contrast with the decreasing trend of greenfield FDI, **mergers and acquisitions (M&A)** suffered less from the slowdown, with the number of projects increasing on average (the total value of these M&A deals is not available) (Graph 6).

### FDI needed

In the short term, FDI is a potential source of **capital formation and job creation**. In countries with declining populations and very sensitive migration flows, a major reason for attracting FDI is to sustain job creation. Since the early 1990s, population levels in the three countries have decreased steadily by 0.5% to 1.5% annually. This trend, which was particularly pronounced during the crisis, recovered partially but is now deteriorating again along with sluggish economic activity (except in Estonia, where the population level has recently stabilised).

Even if not all FDI is **capital formation**, it always entails a long-term commitment and often increases productivity. FDI can be used to finance gross fixed capital formation but also for covering a deficit or repaying a loan, thus having no effect on the capital stock. For instance, cross-border M&A represents a large amount of FDI flows but implies a mere transfer of ownership of existing assets (without new fixed capital formation).<sup>10</sup> Yet, in many cases the incorporation of the purchased firm to its new parent will entail some capital formation. Even more direct is the impact on investment of greenfield FDI, when the parent company sets up a company from scratch developing a plant or building new offices. This type of FDI creates new real assets, increasing the capital stock of the economy as well as its productivity. In short, the connection between FDI and investment is more obvious in the case of greenfield FDI and we can see (Graph 5) that its decline in the Baltics coincides with the weakening of gross fixed capital formation since the crisis.

Graph 5. Greenfield FDI flows

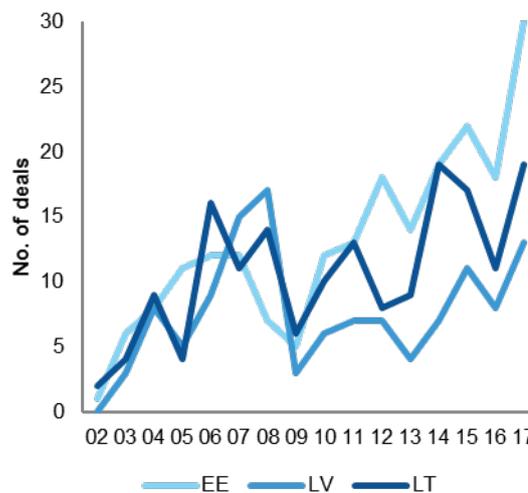


Source: FDI Markets, Financial Times

As already mentioned, in the longer term, FDI is also a channel for technical change. This is particularly important in economies that are still in the process of catching up with the technological frontier. **Technological transfers** result from both direct and indirect effects of foreign investment. A firm taken over by a foreign company will benefit directly from intra-firm technological transfers—the introduction of new techniques in production processes and management and the so-called ‘organisational capital’— or a higher integration in the new parent company’s supply chain, therefore increasing productivity. Indirect effects stem from a variety of mechanisms: increased competition from newly established firms fosters efficiency and innovation in local competitors; the work force improves its human capital via learning from the introduction of more sophisticated goods and production techniques. Spillovers may also be direct via input-output linkages up- and down the value chain: FDI improves the absorptive capacity of firms at the frontier, which in turn spills down to laggard firms in the economy.<sup>11</sup>

These positive effects and spillovers, however, are not irreversible: disinvestments can potentially reverse the benefits from previous investments.<sup>12</sup> Coming up with hard empirical evidence is beyond the scope of this note but it is not unlikely that the poor performance of investment and the vanishing of FDI in recent years are behind the stagnation of productivity in Estonia and Lithuania relative to the EU-15 (Graph 7). Along the same lines, the sophistication of Baltic products is stagnating. The catching up process in general, and FDI in

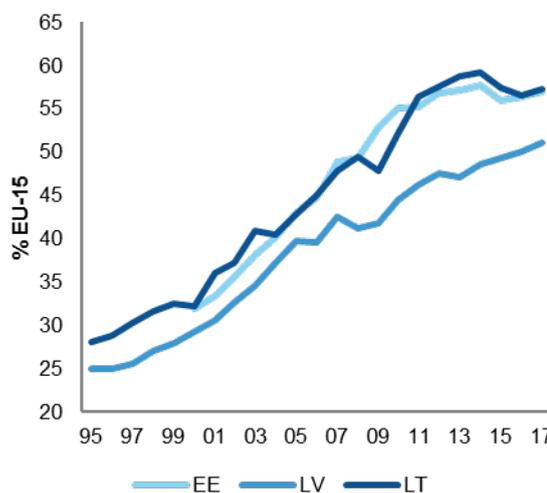
Graph 6. Cross-border mergers and acquisitions (M&A)



Source: Bloomberg

manufacturing in particular, triggered a period during which exports became increasingly sophisticated. The basket of exported products looked increasingly like that of more industrialised countries as measured by the Economic Complexity Index. But complexity has stalled in Latvia and Lithuania.<sup>13</sup>

Graph 7. Labor productivity in the Baltics



Note: GDP in current PPS per hour worked relative to the same ratio for the EU-15.

Source: Commission services, AMECO database

Finally, the absence of FDI affects the integration of local firms in global value chains (GVC) reducing their productivity. Recent research<sup>14</sup> shows that the slowdown of total factor productivity in Central and

Eastern European countries can be attributed almost entirely to the shortening of GVC due to ‘reshoring’. Faltering FDI affects R&D and the absorptive capacity of frontier firms mentioned above, which in turn reduces the spillovers to the rest of the economy.

In short, the collapse of FDI is likely to have had an impact on the drop in capital formation and the slowdown in productivity. However, the effect on productivity may have been attenuated by the sustained volume of cross-border M&A.

### Poor environment, poor expectations

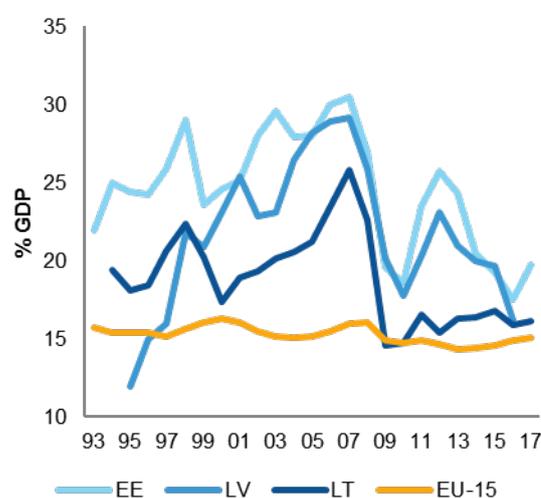
The reason why FDI remains depressed is very likely linked to the **dismal economic performance** of the EU as a whole over the period 2010-2016. For small open economies, market conditions in trade partners can have an important impact on local business perspectives. Deteriorating perspectives particularly affect investment, which is very sensitive to changes in expectations and uncertainty. Today, the investment rate is clearly depressed, close to the EU-15 average (Graph 8). It is then most likely that FDI remains depressed for the same reasons.

Indeed, there is evidence that in the short term it is **business conditions** or prospects that are the main determinants of FDI. A glance at the business cycle (Table A.1) shows that both investment and FDI are strongly procyclical but while investment clearly leads the cycle, for FDI it is less clear cut. A contemporaneous or even lagging FDI would indicate that economic activity has to pick up in order to attract foreign investment again.<sup>15</sup> In turn, the current weakness of economic activity in the Baltics is clearly linked to the poor international environment. A recent Commission paper<sup>16</sup> shows that the crisis and subsequent recovery is largely driven by external developments—with the exception of Latvia where country-specific shocks also contributed to the contraction—and that the current economic weakness is not caused by negative shocks but by the **absence of the external pull** that brought about the short-lived recovery. The major reason for this lack of external pull is to be found in the EU as a whole. Another external source of uncertainty is Russia but from the economic point of view, the EU is by far the most important direct influence on GDP in the Baltic states.<sup>17</sup>

Being a long-term project, investment is not only sensitive to current economic conditions but also to

expectations about the future. For instance, the Economist Intelligence Unit's Country Risk<sup>18</sup> indicator quantifies and compares sovereign risks across countries taking into account six risk areas: sovereign, currency, banking sector, political and economic structure risk. The years leading to the crisis show a constant decrease in this model's sovereign risk and following the crisis we observe a sharp increase. The level of **risk has remained high** despite positive growth in these countries; this permanent increase in the risk can also be observed in other euro area members. This indicates that perceived risks are still present and might deter investment despite the recovery of economic activity in the EU.<sup>19</sup>

Graph 8. Propensity to invest (excluding dwellings)



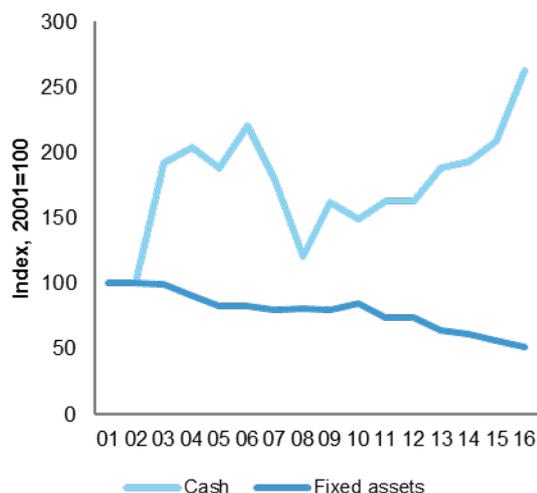
Note: Propensity to invest is gross fixed capital formation as a percentage of GDP. This figure excludes dwellings.

Source: Commission services, AMECO database

But it is probably the financial position of corporations which better illustrates the major role of uncertainty in dampening FDI. Graph 9 displays the evolution of cash and fixed assets relative to the total assets of the companies included in the OMX Baltics Benchmark Index. A slow decline of the fixed asset share and a lasting rise of cash can be observed as early as 2001. In 2008, we see the lowest point as well as the bounce back of the cash share. However, the year 2012 constitutes a clear inflection point for both series: in this year, the rate at which the cash share increases and fixed assets decline accelerates. An increase in **cash hoarding** combined with fixed investment declining is a sign of uncertainty perceived by corporations: treasurers may decide to hold cash rather than use it for investment projects as they are uncertain of how the

future economic and political environment will shape returns on these investments.

Graph 9. Cash holdings and fixed assets in OMX Baltics Benchmark Index companies, percentage of total assets



Note: Indexed evolution the cash and fixed as % of total assets for companies comprising the OMX Baltic Benchmark Gross Index, a NASDAQ index.

Source: Bloomberg

An ambiguous economic climate would negatively impact the availability of investment opportunities, leaving companies with little choice other than to hold cash. This interpretation is consistent with the 2012 turning point observed in the chart. Coinciding with the euro area's second dip, cash holdings accelerate and investment in fixed assets drop.

Last but not least, rising unit labour costs<sup>20</sup> and the consequent loss of competitiveness have been mentioned as a possible reason why FDI has stalled since the crisis. As noted above, at this stage of development, low labour costs may be crucial for certain investment projects targeting exports. While ULC rose significantly between 2010 and 2015, particularly in Latvia and Lithuania, the level remained well below pre-crisis levels.<sup>21</sup> The share of labour in value added—real wages in excess of productivity—is indeed increasing but below the pre-crisis average. In addition, ULC inflation is driven almost exclusively by rising real wages, with inflation and productivity playing a smaller role. It looks like the increase in ULC responds to real labour demand pressures in turn explained by the modest pick up of economic activity combined with a shrinking labour force. While rising labour costs may put company margins under pressure, it is unlikely that FDI is held back by the same positive

prospects that drive labour demand up.<sup>22</sup> Finally, while FDI in tradable sectors is likely to be linked to cost advantages and targeted at exporting activities, the drop in FDI of recent years is across all sectors including those serving local markets. In fact, one of the exceptions to the drop in FDI is precisely manufacturing in Lithuania and to a lesser extent in Latvia. Recent large greenfield investments in the automotive industry in 2017 bear witness of this resilience. This shows that FDI has been particularly resilient precisely in outward-oriented sectors, leaving little room to interpret that it is ULC that is keeping FDI depressed.

### Supporting the recovery

The times of massive privatisations are over and some sectors have already received considerable foreign investment in the past. Nevertheless, the Baltic economies are still some distance from the technological frontier, leaving room (and call for) considerable investment from abroad.

Certain reforms could support the recovery and create the conditions to speed up the process once the recovery of the economy consolidates. Estonia had been in general more successful than its peers at attracting FDI before the crisis. It received annual average inflows of 8.4% of GDP over the last 15 years (compared to Latvia 4.1% and Lithuania 3.8%) and in 2015, its stock stood at 99% of GDP (compared to Latvia 63% and Lithuania 40%). This relative success may be partly due to Estonia's relatively better **institutional environment**. According to the World Economic Forum, in protection of private property rights (both real and intellectual) and judicial effectiveness (and even-handed enforcement of private contracts) Estonia ranks 23 out of 138 countries, compared with Latvia 64 and Lithuania 51 (Table A.2). Estonia also scores better in access to a trained and skilled workforce and ability to train or attract and retain talent. It also has a higher university enrolment rate (73% compared to Latvia 67% and Lithuania 69%) and surveyed executives believe that employees' pay is more closely related to productivity in Estonia than in its peers. Businesses seem to have access to more affordable banking services and find it easier to raise debt and equity financing in Estonia; in financial markets it ranks 22 compared to 52 and 60 for Latvia and Lithuania respectively.<sup>23</sup> On the other hand, Estonia lags behind Latvia in the degree to which bankruptcy laws protect the rights of borrowers and lenders.<sup>24</sup> Other areas for

improvement in Estonia are some barriers to investment such as lengthy insolvency proceedings and the limited protection of minority shareholders.<sup>25</sup>

Fostering investment in education, in intellectual capital, or in institutional quality could help remove the threat of a middle-income trap and at the same time render these economies more attractive to foreign investors.<sup>26</sup> Institutional factors play a key role in cross-border investment. For example, recent Commission research finds that the cost of enforcing contracts or the ease of paying taxes have been shown to be important determinants of the decision to invest in a country.<sup>27</sup> These factors also influence the size of projects once the investment decision has been taken. The protection of incumbents (limiting competition in specific markets) or other barriers to trade and investment (e.g. discrimination against foreign firms) do not affect investment decision but have a detrimental impact on the amount invested once the decision is taken. The differences between the Baltic states therefore point to areas where improvements may be possible.<sup>28</sup>

## Conclusion

The evidence available suggests that uncertainty about business conditions is the main reason why investment in general and FDI in particular remains depressed in the Baltics. FDI is expected to pick up as activity recovers more strongly. The recent peak in greenfield FDI projects in Lithuania points in that direction. Real wages have been increasing fast but the simultaneous drop in unemployment and increase in vacancies point to labour demand pressures caused by the budding recovery. While the time of mass privatisations is over, the Baltic economies are still far from the technological frontier so foreign investment will continue to play an important role in the near future. Putting the emphasis on maintaining and improving the institutional and regulatory environment will help keep investment coming and avert the risk of a middle-income trap.

**Annex**Table A.1. **Cyclical properties of investment and FDI, 1995-2015**

	<i>St. dev.</i>	t - 3	t - 2	t - 1	t	t + 1	t + 2	t + 3
<b>Estonia</b>								
GDP	1.00	-0.01	0.25	0.70	1.00	0.70	0.25	-0.01
I	3.26	-0.01	0.23	0.62	0.89	0.56	0.13	-0.05
FDI	7.43	-0.05	0.24	0.50	0.62	0.60	0.54	0.26
GDP EU-15	0.31	0.09	0.24	0.59	0.86	0.66	0.39	0.22
<b>Latvia</b>								
GDP	1.00	0.08	0.42	0.81	1.00	0.81	0.42	0.08
I	2.95	0.22	0.47	0.79	0.91	0.70	0.22	-0.14
FDI	6.69	-0.35	0.06	0.56	0.65	0.31	0.03	-0.01
GDP EU-15	0.27	0.23	0.42	0.72	0.82	0.61	0.33	0.08
<b>Lithuania</b>								
GDP	1.00	0.00	0.25	0.68	1.00	0.68	0.25	0.00
I	3.08	0.00	0.24	0.67	0.95	0.58	0.08	-0.13
FDI	8.53	-0.30	0.08	0.49	0.64	0.29	0.10	0.24
GDP EU-15	0.34	0.18	0.31	0.60	0.76	0.49	0.27	0.16

Note: Column  $t + k$  contains  $corr(x_{t+k}, GDP_t)$  where  $x_{t+k}$  is the deviation from the Hodrick-Prescott (HP) filter of the corresponding variable in natural logarithm (except FDI, taken in levels and expressed in percentage deviation from the HP trend). The first column contains the quotient of the standard deviation of the corresponding variable to that of GDP.

Sources: Eurostat and own elaboration

Table A.2. **Quality of institutions**

Global Competitiveness Index 2016-2017 edition

<i>rank out of 138 countries (more is worse)</i>	Estonia	Latvia	Lithuania
<b>Institutions</b>	<b>23</b>	<b>64</b>	<b>51</b>
Property rights	25	56	57
Intellectual property protection	26	63	51
Judicial independence	18	66	58
<b>Labour market efficiency</b>	<b>15</b>	<b>34</b>	<b>59</b>
Flexibility of wage determination	1	6	15
Pay and Productivity	12	49	46
Country capacity to retain talent	84	118	106
Country capacity to attract talent	69	118	111
<b>Financial market development</b>	<b>22</b>	<b>52</b>	<b>60</b>
Affordability of financial services	18	51	37
Financing through local equity markets	47	90	82
Ease of access to loans	30	90	53
Legal rights index	28	13	46

Heritage foundation Economic Freedom index

<i>100 is the highest grade (more is better)</i>	Estonia	Latvia	Lithuania
Property Rights	83	73	73
Judicial Effectiveness	83	60	62
Investment Freedom	90	75	70
Financial Freedom	80	60	70

Sources: World Economic Forum and Heritage Foundation

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<sup>1</sup> In the FDI jargon the balance is the difference between net inflows and net outflows. In turn, net flows refer to the difference between investment and disinvestments. For the sake of readability in this paper net flows will be called simply flows.

<sup>2</sup> For evidence linking FDI with long-term growth in developing economies see, for example, Hansen and Rand (2006). For a more nuanced view, specifically on Central and Eastern European countries see Mencinger (2003). For a general overview of theory and empirics of technology diffusion see Keller (2004).

<sup>3</sup> In this paper business or market conditions refer to the combination of productivity and demand factors that affect investment and hiring decisions by firms. Uncertainty about business conditions will lead firms to become more cautious responding to these, e.g. holding back investment projects (Bloom (2009)).

<sup>4</sup> The middle-income trap is "the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries" because for some reason the economy fails to adopt further more advanced technologies; see Aiyar et al. (2013) and references therein.

<sup>5</sup> The source is Eurostat. The reason why the Netherlands appears among the top investors is probably related to their intermediate role: many investment projects are channelled via special purpose vehicles and entities for fiscal and regulatory reasons. See for example Weyzig (2013).

<sup>6</sup> The close financial links between Latvia and Cyprus seem to respond to both legal and illicit activities. The legal motives are often related to tax avoidance. The illicit activities include money laundering from former Soviet states or hiding enterprise ownership to mask conflicts of interest or to keep assets out of reach of local law enforcement.

<sup>7</sup> These are sectors characterised by very low growth of unit labour costs relative to the euro area in the years preceding the crisis. See tables A.1 to A.3 in Durán and Poissonnier (2017).

<sup>8</sup> Here we refer to domestic employment. In Latvia or Lithuania there is not big difference between the domestic and national concepts but in Estonia workers have the option to work in Finland. In fact, during the crisis, as much as 25,000 Estonians, 4.1% of total national employment, worked outside the country. Note that this may also explain, at least partly, why income per head slowed down more in Estonia than in the other two Baltics: while Latvians and Lithuanians tend to emigrate, in bad times Estonians tend rather to work in Finland but remain Estonian residents. In recent years total population has decreased on average between 1 and 2% annual in the two former countries while it has decreased by barely -0.3% in the latter.

<sup>9</sup> Note that there is nothing special about the Baltic states here: FDI collapsed in all Eastern European countries that were recipients of large inflows before the crisis. Large disinvestments were observed across the European Union in 2014. See for example [http://ec.europa.eu/eurostat/statistics-explained/index.php?title=Foreign\\_direct\\_investment\\_-\\_intensity\\_ratios](http://ec.europa.eu/eurostat/statistics-explained/index.php?title=Foreign_direct_investment_-_intensity_ratios)

<sup>10</sup> According to the UNCTAD 2016 World Investment Report M&As represented USD 831 billion in 2016 relative to USD 1.52 trillion of total flows. Whether these amounts translate into fixed capital formation is difficult to tell. There is even the possibility that foreign (financial) capital crowds-out domestic (fixed) investment (see Acar et al. (2012) or Krkoska (2002)).

<sup>11</sup> Borenszteina et al. (1998) for the conditions under which FDI appears to increase productivity more than domestic investment, notably the level of human capital in the recipient economy. See Chiacchio et al. (2017) for the effect of FDI on the absorptive capacity of frontier firms and the trickle-down effect on laggards.

<sup>12</sup> There is scant evidence in this direction but Javorcik and Poelhekke (2017) show for a sample of Indonesian firms that disinvestment is associated with a drop in total factor productivity, output, mark-ups, as well as export and import intensities.

<sup>13</sup> See again Durán and Poissonnier (2017) or the Country Reports 2017 COM(2017) 90. For a connection between FDI and economic complexity see, for example, Javorcik et al. (2017) for a sample of Turkish firms.

<sup>14</sup> See Chiacchio et al. (2017).

<sup>15</sup> Unlike capital formation, there is not theoretical reason to expect FDI to be procyclical. Contessi et al. (2013) note that FDI inflows are countercyclical in developing countries. The authors point as a potential explanation the low price of local firms for potential foreign owners during recessions, particularly if associated with large devaluations or depreciations of the local currency. In more stable countries Canton and Solera (2016) relate this possibility to the serving expanding local markets with increasing purchasing power.

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<sup>16</sup> Poissonnier (2017, Graph 7) decomposes changes in GDP into country-specific shocks, common shocks, and external shocks for the three Baltic economies.

<sup>17</sup> Ibid. The coefficient for Russia's GDP in the VAR regressions (unpublished appendix) is only significant in Estonia where in addition it is four times smaller than the corresponding coefficient for the EU GDP. That said, this is only the impact of economic activity. Any eventual political uncertainty spilling over from Russia is more difficult to quantify.

<sup>18</sup> See [www.eiu.com/landing/risk\\_analysis](http://www.eiu.com/landing/risk_analysis)

<sup>19</sup> Economist Intelligence Unit, Country Risk Model, data retrieved from Bloomberg.

<sup>20</sup> See Graph 6 in the Alert Mechanism Report 2017 SWD(2016) 354.

<sup>21</sup> ULC rose because of real wage inflation unmatched by increases in labor productivity. The increase in real wages is a consequence of labor supply shortages (emigration, skill-mismatch) in face of a take off of demand (reflected in an almost vertical Beveridge curve). See the discussion in section 3.4.4 in the Lithuania Country Report 2018.

<sup>22</sup> The recent rise in real wages reflect a real situation in the labour market, not to a macroeconomic imbalance. This has important policy implications. For example, it would not make sense to recommend wage moderation when it is labour demand pressures that drive up real wages. For a discussion along these lines see again Durán and Poissonnier (2017).

<sup>23</sup> See also Copenhagen Economics (2016, chapter 4) or Šimelytė (2012) for a quantification of the impact of FDI promotion in general in Estonia compared to Latvia and Lithuania.

<sup>24</sup> WB/IFC Doing Business Legal rights index (Table 3). *This index measures the degree to which collateral and bankruptcy laws protect borrowers and lenders.*

<sup>25</sup> See the Estonia Country Report 2017.

<sup>26</sup> See Staehr (2015) for a discussion along these lines.

<sup>27</sup> Canton and Solera (2016, Table 3) quantify the role of a series of usual suspects in both the extensive margin (whether to invest) and the intensive margin (how to invest).

<sup>28</sup> See the second country-specific recommendation for both Latvia and Lithuania (COM(2017) 513 and COM(2017) 514 respectively). This emphasis on the institutional and regulatory environment is even more important in a time in which we even observe reform reversals, notably in some Central, Eastern and Southern countries. See the discussion in Székely and Ward-Warmedinger (2018).

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