1. FLOWS OF FOREIGN DIRECT INVESTMENTS IN THE ESTONIAN ECONOMY

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1.1. Inflow of foreign direct investments into Estonia compared with other transition economies

Systematic and reliable statistics about foreign direct investments (FDI) inflow into Estonia's economy have been available since 1993. Figure 1.1 provides an overview of FDI inflows into Estonia on the basis of quarterly data, adding a linear trend. The inflow of foreign capital has followed certain cyclical patterns, but generally there has been a tendency for quarterly inflows of FDI to grow. The first period of intensive inflow of FDIs into Estonia lasted until the middle of 1994, after which the process stabilised to some degree. In 1995 new growth phases followed and since the second half of 1996 the FDI inflow has been persistently growing. There are various reasons for this irregular behaviour of FDI inflows.

In the early years of transition, the main explanatory factor was the privatization method used by Estonia, in the course of which major state-owned enterprises were sold by tenders in the form of mass privatization rounds. Since privatization of large infrastructure enterprises cannot be called mass privatization, the year 1997 can be considered herein the end of this

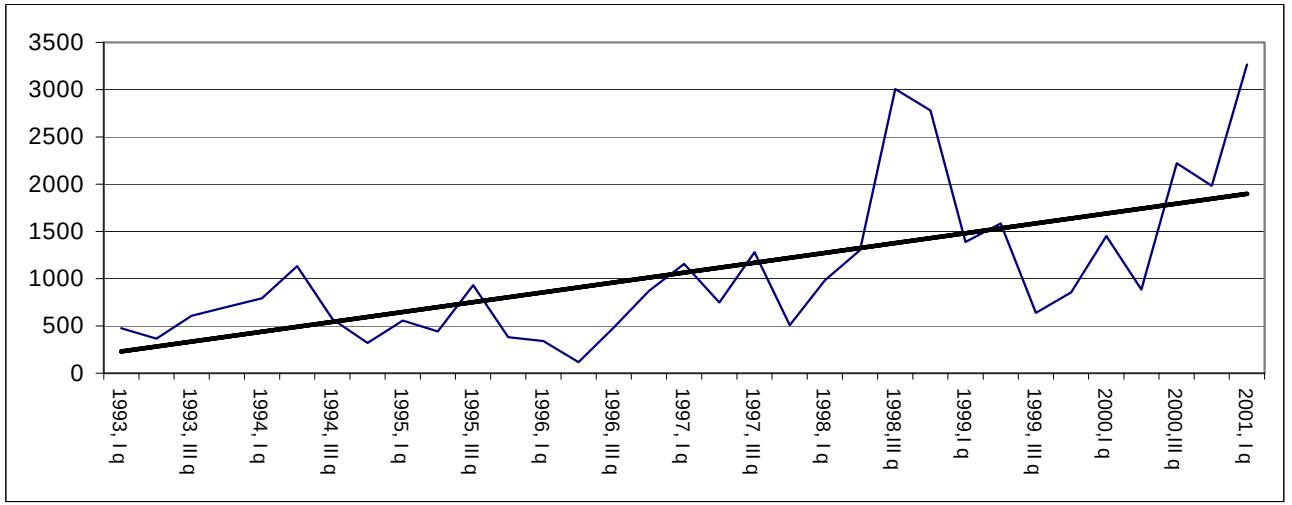

Figure 1.1. Quarterly FDI inflows in Estonia (in million EEK) and the linear trend, 1993–2001 (Balance …, 2001).

type of privatization. However, it should be borne in mind that by 1996–1997 the number of privatization sales transactions had significantly declined and the Privatisation Agency was predominantly engaged in the sale of “larger and more complicated”, partly also “semi-infrastructure” enterprises (shipping companies, aviation firms, etc.). Since the selling prices of such firms were already high enough, foreign capital (including consortia especially formed for the purchase of certain enterprises, and combining foreign and domestic parties) had greater chances to win than domestic bidders as compared to the privatization of “ordinary” enterprises (Terk, 2000).

Since 1997, the structure of FDI inflows has changed. After the privatization rounds the FDI inflows were largely the result of the growth of reinvested earnings of foreign investors and also acquisitions of Estonian privately owned firms and banks. (See also Box 1). The latter form of FDI inflows became evident in 1997 and had taken a leading position by 1998. The most significant examples are Swedfund, buying the majority of shares in Hansapank, the leading private commercial bank in the Baltics, or Skandinaviska Enskilda Banken, buying shares in Ühispank, the second biggest commercial bank of Estonia.

Stabilization in FDI inflows was expected to occur in 1997 and afterwards. In reality 1998 turned out to be the most successful year for Estonia in attracting FDIs. This was primarily connected with acquisitions from foreign investors by Estonian commercial banks and domestic firms, which had been in a predicament after the Russian and Asian crises. In the first quarter of 1999 further privatization of Eesti Telekom was carried out and the government sold 25% of its shares to Sonera and Telia, the Finnish and Swedish firms. The Estonian Government’s privatization plan for the year 2000 included two major deals — the privatization of energy generators and the railway network. In reality, in the case of privatizing power stations,

the negotiations held with the potential investor, US-based NRG Energy, were delayed.

Now the negotiations are at the final stage, but the transaction is not yet absolutely certain. The privatization deal of the Estonian Railway Network was signed in May 2001, but has not yet been finalized: the selling price is about 1 billion Estonian kroons plus investment obligations, but its realisation is still open for a variety of reasons. The inflow of FDIs into Estonia in the year 2000 was 6.8 billion Estonian kroons. The year 2001 started with an FDI inflow of 3.3 bn. EEK in the first quarter, which allows us to predict that in the case of positive realization of the above-mentioned major privatization deals, the year 2001 will become a record year for the inflow of foreign direct investments into Estonia.

In the 1990s a permanent rise in importance of FDIs can be perceived in the transition economies. FDIs have become an essential factor in the facilitation of economic growth in Central and Eastern Europe. There is a strong competition among the transition economies to attract FDIs into their economies. The governments consider FDIs as an important tool in overcoming the problem of insufficient investments by local capital.

In the competition for FDIs Estonia has been rather efficient and has succeeded in attracting a significant amount of FDIs. The following Table 1.1 presents data about the annual inflow of foreign direct investments into ten Central and East European transition countries. The table also contains the total inflow of FDIs in the period 1992–1999 and the total inflow of FDIs per capita in these countries. The data from Table 1.1 indicate that Estonia ranks third after Hungary and the Czech Republic by FDI inflow per capita.

A salient indicator is also the ratio of cumulative stock of FDIs to GDP, which measures the role of FDIs in the economy over the whole period of transition. In 2000 the cumulative FDIs in

Table 1.1

Foreign direct investment flows in the Central and East European Countries, 1992–1999
(balance of payments indicators, in million USD)

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**Total stock**	**FDI per capita (in USD)**
Hungary	1 471	2 339	1 147	4 453	2 275	2 173	2 036	1 944	17 838	1 766
Czech Republic	1 004	654	869	2 562	1 428	1 300	2 720	5 108	15 645	1 519
Estonia	82	162	215	202	151	267	581	306	1 966	1 404
Latvia	29	44	213	178	382	522	356	300	2 024	843
Poland	N/A	1 715	1 875	3 659	4 498	4 908	6 365	6 500	29 520	763
Slovenia	111	113	128	176	186	321	165	83	1 283	642
Lithuania	10	31	31	73	152	355	926	486	2 064	558
Slovak R.	N/A	168	250	202	330	177	566	330	2 023	375
Bulgaria	42	40	105	90	109	505	537	739	2 167	264
Romania	77	94	341	419	263	1 215	2 031	961	5 401	240
Total (10)	**2 725**	**5 360**	**5 174**	**12 014**	**9 774**	**11 743**	**16 283**	**16 757**	**79 830**	**762**

Source: **Hunya, G.**, 2000, p. 13 and EBRD, 2000.

Estonia comprised 48% of GDP, which is one of the highest indicators among the transition economies.

1.2. Change in the structure of FDIs in Estonia between 1992 and 2000

In order to provide more detailed information about the formation of FDIs, Table 1.2 was composed, which clearly demonstrates how the share of investments into new firms (*greenfield investments*) in Estonia has consistently been reduced and replaced by the inflow of share capital into operating firms (*acquisitions*) and reinvested earnings. In the period 1993–1996, the main reason for investing into operating firms was privatization. From 1997 onwards acquisition of Estonian-capital-owned firms by foreign ones started to play a major role. The biggest acquisitions occurred in the Estonian banking system in 1998 and telecommunications in 1999.

Throughout the whole period covered by Table 1.2 the amount of reinvested earnings has been positive. Starting from 1996 the role of reinvested earnings in the total inflow of FDIs has been increasing and stabilized around 20–30% of the total. Another trend is the increase in importance of loan capital in the total inflow of FDIs. In 1994 its share in FDIs was 13.5%. It peaked in 1996, forming 76.2% of the total FDI inflow. Since 1997 loan capital has been losing its importance as a component of FDIs in Estonia, its share having declined to one third of FDIs.

In the year 2000, Estonia introduced a unique taxation system, according to which the reinvested profits of enterprises are exempt from tax. There have been predictions that this tax policy will tempt the foreign-capital-owned enterprises in Estonia to increase their investments as well. So far the results are questionable. A survey conducted at the end of 2000 by the Estonian Institute for Futures Studies among Finnish-owned enterprises showed that most of the respondents considered the

Table 1.2

The structure of FDIs by main components in 1992–2000 (million EEK)

Components	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
FDI balance (net inflows)	**973**	**1989**	**2789**	**2284**	**1330**	**1781**	**7990**	**3208**	**4141**
Outflows	–23	–82	–30	–29	–485	–1913	–82	–1240	–2667
Inflows	997	2071	2819	2313	1814	3694	8071	4448	6807
Share capital	795	1153	1878	1166	216	1361	5662	2552	3702
o/w into new enterprises		764	639	195	49	52	42	45	48
o/w into operating enterprises		389	1239	971	155	1303	5579	2260	3582
Reinvested earnings	112	356	550	178	216	1304	389	1022	1979
Loan capital (net)		553	378	968	1382	492	1397	1110	1245
o/w external assets		–82	–65	–61	–168	–99	–203	–235	–287
o/w external liabilities		635	443	1029	684	591	1600	1346	1531
Other capital		0.0	13	14	866	538	622	–29	–118

Source: Balance …, 2001.

tax deduction positive, though, at least for the time being, that will not hasten them to make larger investments (Terk, Varblane, 2001). But in general, both the volume and structure of FDIs are still very unstable and thus no definite trends can be outlined.

1.3. Geographical distribution of inward FDIs stock in Estonia

First foreign investments in the form of joint ventures had arrived in Estonia as early as a few years before independence was regained in 1991. At that time they primarily came from the neighbouring Scandinavian countries, particularly from Finland. This can be associated with Estonia's physical and cultural proximity to those countries, which is also evidenced by our close trade relations. Investors in the Nordic countries have a better overall picture of Estonia's transition processes and easier access to information. Likewise, a number of them have previous experience of co-operation with Estonian businesses. (See Borsos-Torstila, 1999)

Table 1.3 describes the geographical structure of FDI inflows into Estonia between 1993 and 2000. The first conclusion drawn from Table 1.3 is about geographical closeness as an important factor influencing investment flows. Finland and Sweden have continuously competed for positions in the Estonian market, but since 1995 Danish and later Norwegian firms have been joining them. In 1998 Sweden took over from Finland the position of the leading foreign investor country into Estonia. The role of foreign direct investments from Russia has been rather moderate, and they are concentrated primarily in a limited number of major enterprises.

The second conclusion is that after a certain waiting period multinationals from the USA (Coca-Cola, Coastal Corporation, Texaco, NRG Energy), UK and the Netherlands (Shell) also started to enter Estonia. But their commitment is not very

Table 1.3

Distribution of FDI inflows in Estonia by source country in 1993–2000
(% of all investments in the current year)

Country	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Finland	32	24	9	35	31	21	37	39
Sweden	29	23	43	9	10	59	33	40
USA	0	6	9	28	4	2	8	2
Denmark	0	0	3	10	6	6	7	2
Germany	2	2	0	4	5	3	2	3
Netherlands	6	0	0	1	6	1	0	4
Russia	3	12	0	0	0	0	2	0
Singapore	0	0	14	0	2	0	0	0
UK	0	3	8	2	5	5	3	2
Austria	0	2	3	3	2	0	1	0
Norway	0	0	3	4	21	3	4	1
Other	28	28	11	11	10	0	3	7

Source: Balance …, 2001.

strong as Finland, Sweden, Denmark and Norway together accounted for up to 74.5% of all foreign investments in 2001 (see Table 1.4). The share of world's five largest investor countries USA, UK, Japan, Germany and France was only 16% of all FDIs in Estonia. The third conclusion that can be drawn is about the growing concentration of FDI source countries. During the period covered by Table 1.4 the share of the selected 11 nations in all FDI inflows into Estonia increased from 72% in 1993 to 97% in 1999. Maybe partly it could be explained by the existence of the first mover advantage of firms from these early investing nations, which creates entry barriers to other investors. The fourth conclusion is about the very small size of Estonia's economy, which means that even relatively limited investments play a highly relevant role in shaping the geographical structure of FDIs.

Table 1.4

The structure of FDIs stock in Estonia by countries
(as of 31 March, 2001)

Country	FDIs stock (m EEK)	Share in %
Sweden	17 619 080	37.6
Finland	13 447 425	28.7
Netherlands	2 540 621	5.4
USA	2 090 451	4.5
Norway	1 940 572	4.1
Denmark	1 913 271	4.1
Germany	1 434 047	3.1
Great Britain	1 200 903	2.6
Russia	789 103	1.7
Liechtenstein	743 225	1.6
Singapore	481 387	1.0
Switzerland	384 581	0.8
Italy	360 317	0.8

Country	FDIs stock (m EEK)	Share in %
France	200 722	0.4
Others	1 774 795	3.6
Total	**46 920 500**	**100.0**

Source: Balance …, 2001.

The structure of FDIs in Estonia by source countries differs considerably from that of the other transition countries by the leading investor countries, but is rather similar by the basic trends behind the formation of major source countries. Table 1.5 reveals that in many cases the pattern of investments appears to reflect geography. Proximity of transition economies to the markets of industrialized countries and the availability of a relatively highly skilled but cheap labour force have led to inward investment from the neighbouring countries. For example, German investments form 26% of all FDIs in the Czech Republic, 25% in Hungary and 19% in Poland. Austrian investments in Slovenia and Hungary or Italian investments in Slovenia can be said to follow the same tendency. Therefore the leading position of Finland and Sweden in Estonia accords with one and the same general trend.

However, large strategic investments have also been made throughout the region by major multinational firms from more distant economies, such as the USA, the UK, the Netherlands, Switzerland and Korea.

This can be explained by their desire to acquire big domestic markets of Poland and Russia, but also of Hungary and the Czech Republic. An important role in promoting their decision to enter has also been played by the opportunities offered by privatization. Estonia’s tiny market and lack of important natural resources have left the country outside the primary interest of big multinationals, whose interest in Estonia is mainly connected with further expansion to the Russian or Ukrainian markets, but the impact of that factor cannot be considered very significant so far. Although Estonia was advertised in the early

Table 1.5

Distribution of the total stock of FDI inflows in the transition economies by source country
(as of December 1998, shares in %)

Home	Czech	Hungary	Poland	Romania	Russia	Slovenia	Estonia
USA	13	15	18	7	29	4	4
Germany	26	25	19	10	12	12	2.5
Netherlands	16	15	7	15	4	4	2
UK	7	8	7	5	17	5	3
France	7	6	9	8	2	13	0
Switzerland	9	3	2	2	15	3	1
Austria	8	11	3	5	2	38	1
Italy	2	3	8	8	3	7	1
Korea	...	1	6	11	...	…	0
Belgium	…	4	1	…	…	…	0
Japan	…	2	…	…	…	…	0
Sweden	N/A	N/A	3	N/A	1	N/A	41
Finland	N/A	N/A	1	N/A	0	N/A	30
Others	15	9	18	39	17	25	22

Source: Countries …, 1999; Balance…, 2001.

1990s as a gateway to Russia, the studies of the mid-1990s (see Kliimask, 1995, p.17) already showed that the Russian factor served as a positive incentive to investors only in the transit-transportation sector, whereas investors in the other sectors primarily reckoned with the Estonian, Baltic or Western own markets.

1.4. Structure of inward FDIs in Estonia by sectors and industries

The structure of inward FDIs by sectors of economy was rather stable during the first years of transition, 1993–1995, the manufacturing industry being the main recipient, followed by the wholesale and retail sales sectors. These two sectors of economy covered nearly 70% of the FDI inflow (see Table 1.6).

Since 1996 the importance of the manufacturing industry as the target for FDIs has decreased and the financial sector together with the transportation and communication industries has become more attractive to foreign investors. Changes in the structure of FDI inflows reflect the dynamics of the privatization programme of the Estonian Government. In 1996 flows into the manufacturing industry started to decrease because no large privatization projects were undertaken in this sector.

At the same time, sizeable investments were made into enterprises of infrastructure and transport. In 1998, the inflow of foreign capital into Estonia’s banking sector was the most specific feature, being the result of Swedish investments into two leading commercial banks of Estonia.

Investments into the energy sector remained modest until 1999, although it needs considerable investments in order to restructure Estonian energy production, which is based on oil shale. In 2000, important progress in the privatization of the energy sector was achieved when Estonia’s biggest power station was sold to the US multinational NRG Energy.

Table 1.6

Distribution of FDI inflows in Estonia by sectors of economy, 1993–2000 (%)

Economic sector	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Manufacturing industry	45	51	45	24	36	19	25	18
Wholesale and retail trade	26	15	24	36	9	12	8	10
Transport, storage and communica-tions	0	21	11	3	25	4	25	14
Agriculture	0	3	5	*	0	1	3	2
Finance	8	2	7	27	16	53	21	27
Real estate, rental and business activities	7	3	0	*	5	5	8	15
Other	14	5	8	10	9	6	10	14
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Balance …, 2001.

By the end of the first quarter of 2001 the major part of the stock of FDIs – 79.7% – was concentrated into four sectors of economy (see Table 1.7). The biggest part, 23.4% of the total stock was located in financial intermediation followed by the manufacturing industry (21.6%), transportation (18.9%), and wholesale and retail trade (15.8%). Lately the concentration of FDIs into these four sectors has declined and foreign investments are now distributed more evenly between different sectors of economy.

In order to present a comparative insight, a detailed distribution pattern of inflows of FDIs into some transition countries is given, classi-

Table 1.7

Stock of FDIs by fields of activity (end of March, 2001)

Activity, sector	FDIs (m EEK)	Share in %
Financial intermediation	11 001 414	23.4
Manufacturing	10 135 251	21.6
Transportation, communication	8 888 533	18.9
Wholesale and retail trade	7 402 794	15.8
Real estate and business activities	3 329 298	7.1
Electricity, gas and water	2 992 812	6.4
Hotels and restaurants	850 840	1.8
Construction	656 656	1.4
Agriculture	655 303	1.4
Other	228 333	0.6
Mining and quarrying	194 123	0.4
Education	15 525	0.0
Fishing	10 001	0.0
Health and social care	5 060	0.0
Public administration and defence	1 134	0.0
Not classified	781 820	1.7
Total	**46 920 500**	**100.0**

Source: Balance …, 2001.

fying economy into the primary, secondary and tertiary sectors. Table 1.8 reveals in general terms that the pattern of FDIs in Estonia is similar to those of the other transition economies, with the secondary and tertiary sectors being relatively successful in attracting FDIs, and the primary sector behaving weakly. But in some sense the structure of inward FDIs in Estonia is more advanced than in many other transition economies because the tertiary sector accounted for nearly 63% of the whole FDIs inflow in 1997. This is the highest ratio among the group of countries selected into Table 1.8, followed by Hungary with 59, Slovenia with 55 and the Czech Republic with 45%. In the subsequent years the share of tertiary economy continued to grow in Estonia and reached 73.6% in 2000.

Table 1.8

Sectoral and industrial distribution of FDIs in the transition economies in 1997 (%)

Sector/Industry	Czech	Hungary	Poland	Romania	Russia	Slovenia	Estonia
Primary sector	**…1**	**2**	**2**	**6**	**16**	**…**	**1.5**
Agriculture, forestry	…0	1	0	2	…	…	1.2
Mining, petroleum	…1	1	2	4	16	…	0.3
Secondary sector	**38**	**39**	**61**	**53**	**23**	**30**	**33.4**
Food, beverages	16	9	21	14	9	2	
Textiles, leather	…	2	3	4	…	…	
Wood, paper	…	3	5	5	3	6	
Chemicals, petroleum products	8	8	5	5	3	6	
Cement and building materials	…	3	6	6	…	2	
Basic metals	…	2	1	1	3	…	
Machinery, equipment	…	12	17	14	4	5	
Electrical machinery	1	…	…	3	…	…	
Automotive	13	…		3	…	…	
Unspecified	…	0	3	…	…	7	
Tertiary sector	**45**	**59**	**38**	**35**	**51**	**55**	**62.9**

Sector/Industry	Czech	Hungary	Poland	Romania	Russia	Slovenia	Estonia
Electricity, water	4	14	…	…	…	14	0.6
Construction	1	4	5	1	…	…	1.2
Wholesale and retail	9	12	6	16	11	11	25
Tourism	…	2	…	4	5	…	1.2
Transport, communication	18	8	5	4	2	…	10.2
Finance and banking	9	9	21	5	32	17	15.8
Real estate	3	8	…	4	…	13	8.1
Public administration	…	2	0	1	1	…	0.8
Unspecified	**17**	–	–	**6**	**10**	**15**	**2.2**

Source: World Investment Report, 1998 and Balance …, 2001.

In the opinion of the UNCTAD experts, the tertiary sector or services will be the main field of attraction for FDIs in the following period 1999–2002 (WIR, 1999). They also stress the idea that the tertiary sector with such important infrastructure elements as telecommunications, transportation, banking and insurance, wholesale and retail trade could make important contributions to the transition to market economy. Therefore the inflow of FDIs into this sector might be especially valuable, in order to bring about rapid transformation of these economies. Comparing the structure of inward FDIs in Estonia with that in Hungary, the most advanced transition economy, one can conclude that Estonia has still several areas of economy with insufficient FDI coverage. This primarily concerns the electricity and water supply industries, where Hungary has 14% of all inward FDIs against the meagre 1% in Estonia.

1.5. Regional distribution of inward FDIs in Estonia

Foreign direct investments are distributed extremely unevenly inside Estonia. Unfortunately, the Balance of Payments Department of the Bank of Estonia does not regularly publish data on regional distribution of FDIs and the latest complete data are about early 1998, and data about major regions about late 1999. But in general terms the situation has not changed. The majority of all foreign investments, over 80%, are concentrated into the capital area around Tallinn and Harjumaa County. Furthermore, about one quarter of the enterprises in Harjumaa belong to foreign owners. The next preferred region, Tartu, remains far behind with less than 10% of FDIs with about 18% of the enterprises belonging to foreign owners. Table 1.9 indicates that foreign investments into other eleven counties are fourteen times smaller than those into Tallinn and Harjumaa County, making up only 19.2%. Therefore unequal regional distribution of FDIs in Estonia is rather similar to that

in other transition economies, for example, Poland or Hungary, where investments are concentrated around the capitals or into border areas with major investor countries.

Table 1.9

FDIs stock by regions of Estonia in 1996–1999

Region	% as of 31.03.96	% as of 31.12.97	% as of 31.12.99
Tallinn	71.7	73.3	80.1
Kohtla-Järve	2.6	1.6	N/A
Narva	N/A	0.4	N/A
Pärnu	2.1	1.6	1.9
Sillamäe	N/A	0.0	N/A
Tartu	1.9	2.0	N/A
Valga County	N/A	0.4	N/A
Viljandi County	N/A	0.7	N/A
Võru County	N/A	1.0	N/A
Jõgeva County	N/A	0.6	N/A
Saaremaa County	N/A	0.4	N/A
Ida-Virumaa County	N/A	1.3	N/A
Järvamaa County	N/A	0.3	N/A
Põlva County	N/A	0.4	N/A
Pärnu County	1.4	1.7	N/A
Lääne-Virumaa County	4.3	2.6	3.0
Rapla County	1.1	3.1	N/A
Tartu County	N/A	1.0	N/A
Läänemaa County	N/A	0.3	N/A
Harjumaa County	9.7	7.5	8.8
Hiiumaa County	N/A	0.0	N/A
Total	**100.0**	**100.0**	**100.0**

Source: Balance …, 2001.

There are many reasons why investors first started to invest into the area around Tallinn. Firstly, its well-developed infrastructure and the Tallinn-Muuga Harbour, which is one of the most modern ones in this region. Secondly, the existence of many state-owned firms in the early 1990s waiting to be privatized. The third argument in favour of the area around the capital was the availability of relatively skilled labour. The fourth argument is rather specific and related with the fact that owing to the availability of Finnish TV broadcasts in and around Tallinn since the 1960s many people in that area can speak Finnish, which provides a unique opportunity for Finnish small and medium-size firms to do business abroad in their mother tongue.

In many cases Tallinn and Helsinki are more closely linked than Helsinki with other Finnish towns in the Nordic area. One might expect that in the long run very quick development of infrastructure areas outside the capital and lower production costs there would cause redirection of investments to the areas lying farther off from capitals. However, in the period 1993–1999 the concentration of FDIs into Tallinn and Harjumaa County did not diminish significantly.

The actual effect of FDIs on growth may have been reduced by this uneven regional distribution. The high concentration in the Tallinn area has increased inflation and other negative effects of urbanization, such as crowding, reducing its productivity and consequently that of the economy. Many foreign investors have been subjected to these adverse effects of excessive urban primacy, reflected especially in the escalation of rents and wage costs, as the influx of immigrants has raised housing costs and property prices, and labour shortages have raised capital intensity and training. Average monthly wages at the end of 1998 were 70% higher in Tallinn (5511 kroons) than in Võru (3221 kroons) and 43% higher than in Tartu (3855 kroons). The wages and turnover are highest in the tertiary sector, especially in the financial services sector. But despite these hindrances the inflow of FDIs is still concentrated into

the area around Tallinn and the surrounding Harjumaa County, where 88% of all investments were located by the end of 1999.

1.6. Outward FDIs from Estonia

Internationalization of Estonian firms was accomplished in early 1990 primarily by using indirect and direct exports. As late as 1996 Estonian firms started to use investments as a method for entering foreign markets (see Figure 1.2). It was followed by the first significant outflow boom year of 1997 with outward FDIs totalling 1.913 billion EEK, when Estonia was the leader among outwardly investing transition economies by per capita indicators. This was followed by a heavy fluctuation and stagnation of outward FDIs in 1998. High volatility of FDI outflows appears to be characteristic as the total stock of FDIs abroad is really very limited. Even a single operation of reducing investments abroad would cause significant changes in outflows.

After the Russian crisis in late 1998 the FDI outflows were replaced by the process of withdrawing loans from the affiliates of Estonian firms abroad, which is shown in Figure 1.2 by negative FDI outflows in the third quarter of 1998. Together with general improvement of the economic climate in Estonia in the second half of 1999 the outflows of FDIs from Estonia increased again, peaking at the beginning of 2000.

The total stock of outward FDIs of Estonian residents amounted to 4.65 billion EEK at the end of March 2001, which is eight times less than inward FDIs. However, the outward flows of FDIs between 1993 and 2001 follow an increasing trend, which is shown in Figure 1.2. This indicates that Estonian firms are entering a new stage of internationalization, where also investments will be used in addition to exporting. In the first stage it is still mainly related with opening of small distribution networks in the target export countries like Latvia and Lithuania, which together formed 87% of all outward investments of Estonia (see Table 1.10).

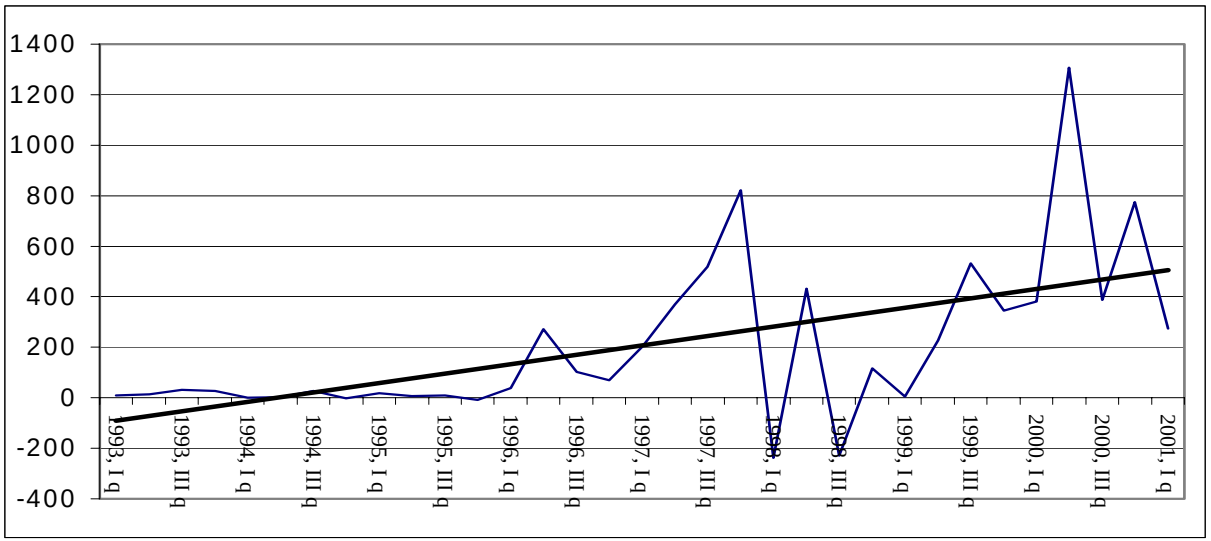

Figure 1.2. FDI outflows from Estonia in 1993–2001 (million EEK) and the linear trend (Balance …, 2001).

Table 1.10

FDI outflows from Estonia (end of March, 2001)

Target country	Stock (in thousand EEK)	Share of total outward stock (%)
Latvia	1 999 575	43.0
Lithuania	1 474 369	31.7
Cyprus	586 740	12.6
Ukraine	80 778	1.7
Russia	80 704	1.7
Poland	51 661	1.1
Sweden	32 124	0.7
Others		7.5
Total	**4 652 255**	**100.0**

Source: Balance …, 2001.

Table 1.11

The structure of the Estonian outward FDIs stock
(end of March 2001)

FDIs from Estonia abroad	In thousand EEK	As share of the total stock (%)
Financial intermediation	1 406 246	30.2
Real estate and business activities	1 164 237	25.0
Manufacturing	801 546	17.2
Transportation, communication	795 913	17.1
Trade and repairs	390 680	8.4
Construction	43 964	0.9
Not classified	49 714	1.2
Total	**4 652 300**	**100.0**

Source: Balance …, 2001.

According to Table 1.11, the major group of outward investments (60.3%) derive from the banking sector, which indicates that the domestic market is becoming too small for Estonian commercial banks and they are entering the neighbouring Baltic markets. The major investors were Hansapank and Ühispank, two biggest commercial banks of the Baltics, who bought several Latvian and Lithuanian small commercial banks. This also explains why the biggest part, 60.3% of total outward FDIs of Estonian firms were made in the form of loan capital. The role of share capital in all outward FDIs was only 29% and the share of reinvestments only a tiny 3% in 1997.

Firms from the manufacturing industry have not used outward investments widely as a method for entering foreign markets. This has mainly been associated with small investments in the food processing industry. The total amount of outward investments made by the manufacturing industry in 1994–2001 equals 801 million EEK or only around 100 million DEM (see Table 1.12).

1.7. Further prospects for FDI inflow into Estonia

As we saw above, the inflow of FDIs into Estonia after the completion of mass privatization has become significantly more uneven per year and quarter, but has generally retained an almost linear growth tendency. Different opinions have been voiced on whether or not this tendency will continue. On the one hand, it has been claimed that, when comparing Estonian per capita FDI figures with those of Western and Northern Europe, Estonia has a lot to aim at. Accession to the EU and the strengthening of the Baltic Sea regional co-operation should have an accelerating effect on the FDIs.

On the other hand, more pessimistic views have been expressed as well. For example, the 1999 and 2000 estimates by the Estonian ministries of economic affairs and finance (Estonia 2001) predict the rise of the inflow of foreign investments and the growth of the ratio of FDIs to GDP in the immediate future, largely due to the privatization of infrastructure enterprises. From 2003–2005 onwards, however, they forecast a moderate decline. The Ministry of Economic

Table 1.12

FDI outflows from Estonia by fields of activity in 1994–2000 (thousand EEK)*

	Field of activity	1994	1995	1996	1997	1998	1999	2000
A	Agriculture	0	0	0	x	x	x	x
B	Fishing	0	0	0	x	0	0	0
D	Manufacturing	30	–6 728	–46 282	–202 700	42 432	–336 447	–276 097
E	Electricity, gas and water	0	0	0	0	0	x	x
F	Construction	0	–591	–787	–13 587	4163	12 230	–21 930
G	Trade and repairs	–6 611	–20 164	7 185	–74 452	–178 545	–3 414	–6 782
H	Hotels and restaurants	0	0	0	x	x	x	x
I	Transport, communication	0	–3 054	–255 627	–325 489	389 954	34 145	–79 193
J	Financial intermediation	x	x	–172 850	–1 107 616	–317 479	–734 879	44 115
K	Real estate and business activities	x	4 673	–10 852	–176 170	–8 961	–96 378	–683 169
L	Public administration and defence: compulsory social security	0	0	x	0	0	0	0
O	Other	920	29 253	45 083	–595	53 060	60 853	–7 514
X	Unknown	–30 000	760	x	–2806	–4 056	14 831	
	Total	**–29 000**	**–29 100**	**–484 500**	**–1 912 000**	**–81 700**	**–1 107 600**	**–1 043 100**

* – data were drawn from the balance of payments statistics, therefore the negative figure shows the outflow;
x – data are not available as less than three investments were made.

Source: Balance …, 2001.

Affairs estimates predict a decline from 10% (in the near future) to 7% of GDP (in a longer perspective). It is hard to predict the volume of FDIs inflow because the process is simultaneously influenced by geoeconomic and geopolitical factors and those caused by the country's transition dynamics. In our opinion, it would be reasonable to address at least the following individual factors (see also Terk, Varblane, 2001):

1. Considering the central role of the infrastructure systems in economy and the scarcity of capital characteristic of Estonia (similarly to other transitional countries), privatization of infrastructure enterprises will certainly become an important channel of foreign investments inflow. But several circumstances which complicate the situation should be mentioned here:
   a) The sale of infrastructure enterprises is a politically sensitive sphere. Even in the presence of a political resolve (to orient to foreign investors when selling) the actual execution of sale need not be necessarily certain and the sales may be delayed. A recent example of this type of problems is around the privatization of the Estonian Railway Network.
   b) The volume and schedule of payment of the foreign currency connected with such sales does not only depend on the price and the moment of selling, but also quite significantly on the terms of sale. A maximum selling price is usually not the goal here; the agreement aims to ensure that the new owner would make further investments.

2. While the low cost of production input in Estonia was certainly one of the basic motives for investing in the previous period of economic transition, the importance of this factor can be expected to decline now. This is, on the one hand, due to the inevitable rise of the prices for public sector services, and, on the other, the side effects of joining the EU. There are forecasts, according to which the current price level of Estonia, which is now (in the middle of 2001) approximately 60% of that of the EU, will rise in case of successful accession to more

than 70% of the EU price level by 2005 (Raim, Terk, 2000). Wages and other expenses tied to the exploitation of labour will rise at a significantly faster rate and therefore the foreign investments primarily aimed at saving on costs may be replaced by investments made for other motives (market-seeking, strategic-assets-seeking). The emergence of new motives in investment will again be linked to a number of exogenous and endogenous factors (local development policy, geopolitical factors, etc.).

3. A significant factor generating new foreign direct investments is the extent of networking between the existing firms in Estonia. In includes expansion of the existing foreign-owned enterprises through initiating new subcontracting orders to the domestic firms and also more active co-operation between foreign-owned firms themselves located in Estonia. In Estonia, a good example is provided by the establishment of the Finnish-owned JOT Eesti OÜ, which produces equipment and assembly lines for electronic enterprises and provides its services to Estonia's largest export firm, the electronics plant Elcoteq, which is also Finnish-owned. It is further connected with more than 30 subcontractors in Estonia. Unfortunately, such examples are still scarce and it is hard to predict the rate of the process "one foreign investment initiates others".

4. The EU accession process will certainly have, despite its effect of price convergence, a generally positive impact on further foreign investments. As has been shown (Winners, 2000, p. 17–51), this effect will start several years before the country's formal accession to the EU. But in case of Estonia some specific aspects should be considered.

a) Regarding Estonia, due to the very liberal foreign trade policy and the existence of rather advantageous free trade agreements with the EU (incl. free trade in textile products), there is no reason to presume that the foreign firms investing in Estonia and producing export goods will get significantly better access to the EU markets than they already have. Practically the only exception here is

the food sector. The difference may become apparent in case of those enterprises that provide services rather than those that produce goods.

b) The overall similarity of legislation, improvement of market information, decrease of fear of risks, etc. are important to investors located further away from Estonia than to the main investors so far — Finns and Swedes. Therefore the extent of the extra effect accompanying EU accession will depend on the reaction to Estonia's "Europeanization" by the hitherto not very active investor nations: Japan, the USA, Germany, the UK. But for these countries, the idea of Estonia already being "occupied" by the Nordic countries' corporations may play a rather important role.

5. The strength of Estonia's foreign investment situation so far has been that the country was involved, via the foreign investments, with the Nordic countries' high technology clusters. At the same time, the high technologies, especially the IT cluster firms, are very vulnerable to the world market dynamics. The first signs of the realization of that threat have already reached Estonia: termination of the Ericsson cellular telephone production in the Elcoteq Tallinn plant, concerns over the state of subcontracting orders from the Finnish multinational Nokia, etc. On the other hand, the crisis situation may also serve as an incentive for accelerated transfer of certain industries with expensive production input from the Nordic countries to less expensive Estonia.

6. A special issue is the foreign investments into Estonia based on business with Russia. In case of successfully developing economic relations between the EU and Russia and provided that the Estonia-Russian relations will not face a crisis, there exists a potential for investments. It is primarily in the field of investments connected with the value added to the raw material flow from Russia through Estonia to Europe — for example, the current major investment of a US firm in Russian metal processing facility is the Tallinn port. Another area for

investments is the servicing of the future flow of capital goods from the West to Russia. But business with Russia is prone to changes and is strongly dependent on the foreign political climate. In case of increased domestic consumption in Russia, the flow of raw materials and energy carriers through the Baltic states to the West will probably decrease.

7. A significant role in achieving long-term attractiveness of the country to foreign investors is played by Estonia's own development policy. The realization of some elements of that policy (education and training, product and technologies development) within the EU framework is easier, while that of others, like tax policy, are more complicated.

In conclusion one can say that there are good reasons to forecast a strong future inflow of foreign direct investments into Estonia's economy. But future FDI flows will be formed as a consequence of realizing different scenarios of development, which combine the process of European integration, the geopolitical situation in the region, the state of the world economy, and the development policy of the country itself (see Terk, Raagmaa, 2000).

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