

# Internationalisation of Estonian Economy through Foreign Direct Investments (FDI)

by Alari Purju

Post-socialist economies have, in general, low levels of domestic savings due to their low levels of incomes. The source of foreign direct investments (FDI) is foreign saving and so additional resources will be available, contributing to the process of restructuring, economic growth and the development of technology in the recipient countries. Estonia has been one of the most successful Central and Eastern European countries in attracting FDI on a per capita basis. In addition to invested resources, the spill-over of business culture, plus an additional demand for local companies are important results of the FDI-s.

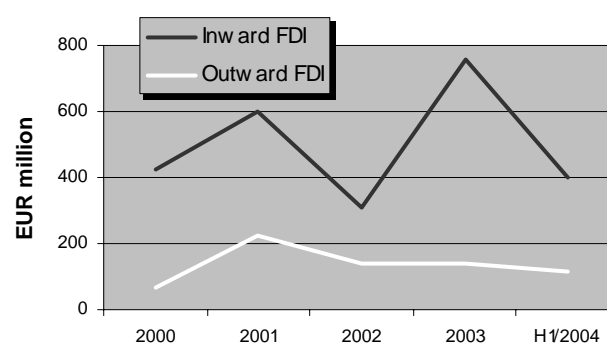
There are, in principle, three components in FDI: equity capital - the purchase by foreign direct investor's shares of an enterprise in a country other than its own - reinvested earnings and intra-company loans or intra-company debt transactions. The inward and outward FDI-s have been different sides of the same coin and created a basis for the internationalisation of economy.

The Estonian economy is closely connected the economies of Finland and Sweden via trade linkages. These countries are also the two most important sources of inward FDI, creating together 67% of the FDI-s into Estonia. Sweden is Estonia's greatest single FDI investor. The bulk of the FDI from Sweden has gone into the Estonian banking, transport and communication sectors. The major part of FDI from Finland has been directed towards the manufacturing, transport, trade, construction and real estate sectors. One reason why Finnish investors invest more in wholesale and retail trade is that majority of tourists visiting Estonia come from Finland. Those companies are also serving tourists in Estonia, especially in the capital. On the 30th June 2004, FDI into Estonia formed EUR 5.9 billion. The income of foreign direct investors in 2003 was EUR 543 mln or 10.6% from all invested money (direct investment stock in Estonia). From earned money, EUR 403.5 mln or 74.3%, was reinvested. The FDI-s have annually created up to one third of the gross fixed capital formation of Estonia.

The majority of Estonian outward FDI was converted into real estate, rent and business services and the finance. Approximately two thirds of the FDI went into Latvia and Lithuania. The total amount of outward FDI was EUR 938 mln on 30th June 2004. For further analysis of sources of outward FDI-s, it is reasonable to separate direct and indirect investors. Direct investors are domestically-owned firms from that country. Indirect investors are themselves affiliates of foreign parents, located outside a country.

On that basis, it is possible to separate into two periods, outward FDI from Estonia. Until 1998, locally-owned Estonian companies formed the majority of Estonian outward investors. After the financial crises in Russia in August 1998, Swedish commercial banks acquired the majority of shares in the two largest Estonian banks. The target of those bids was the already created Baltic network. On a minor scale, that also occurred in other sectors. So, the majority of Estonian outward investments have been acquired by foreign firms and the Estonian direct outward FDI projects were transformed into indirect ones in that process.

## Inward and outward FDI in 2000-2004



The FDI-s played a major role in internationalising economies, linking the business units in different countries into a joint network. The inward FDI have been a pre-assumption for outward FDI during the second stage of that process. Prospective EU membership also played an important role, targeting the Baltic market as an overall region. It was possible to forecast that they would become EU members in the near future. This meant the harmonisation of the institutional framework and lower transaction costs for foreign investors. Estonia is a connecting link and firms registered in Estonia function as agents of Swedish and Finnish outward investors targeting the Baltic markets as a wider area for economic activities. The question for future research would be the role of Estonia as a possible mediator for Scandinavian investments towards Russia after EU enlargement.

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## Estonia's FDI, EUR million

Indicator	2000	2001	2002	2003	H1/2004
GDP (current prices)	5 926	6 304	6 761	7 109	4200*
Gross fixed capital formation	1 519	1 798	2 145	2 285	1350*
Inward FDI	424	603	307	756	398
Outward FDI	66	225	140	137	118
Gross fixed capital formation / GDP (%)	25.6	28.5	31.7	32.1	32.1
Inward FDI / GDP (%)	7.2	9.6	4.5	10.6	9.5
Inward FDI / Gross fixed capital formation (%)	27.9	33.5	14.3	33.1	29.4

Sources: Statistical Office of Estonia, Bank of Estonia, author's calculations \*estimate