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WHY DO FIRMS INVEST IN THE BALTIC SEA REGION?

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The research report is a part of the BaltMetPromo project, co-financed by the Baltic Sea Regional Programme of the European Union. The project focuses on the attractiveness of the Baltic Sea Region as a target for foreign direct investment (FDI), tourism and talent. In each of these areas two research reports have been prepared: one concerning the demand side, and the other the supply side. Our report focuses on the demand side of FDI. The end products in each sector are several types of concrete marketing measures for relevant target groups. (See http://www.baltmetpromo.net/public/).

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ABSTRACT: We have defined the Baltic Sea Region as consisting of the following countries and regions: Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden, and the regions of St Petersburg, Leningrad Oblast and Kaliningrad in Russia. We have investigated the factors affecting FDI in the Baltic Sea Region in three ways. First, we have studied the factors affecting FDI on the basis of the existing theoretical and empirical literature. Secondly, we have studied the characteristics of the existing FDI in the Baltic Sea Region. Thirdly, we have researched the investment motives through two firm questionnaires: 1) firms participating in the MIPIM real estate fairs and 2) Finnish firms active in the Baltic Sea Region (Finpro register). The common results of both empirical enquiries were: 1) the most important reasons for FDI are market size and its growth potential, 2) companies do not see the BSR as a single market in their actual decision making process, 3) there are clear benefits in having the non-Euro area countries as members of the EMU, but the results are not very robust: obviously they are weakened by the already rather credible pegs of the Estonian, Danish, Latvian and Lithuanian currencies and the diversification benefits of the floating Swedish krone, and 4) governmental investment promotion organizations have a rather small role in the actual investment decision making process. Their role is rather in giving general information on the country's investment environment. The most important differences between the samples of firms are: 1) in the real estate sector the majority of FDI is done through buying an existing firm, whereas in the sample of Finnish firms most FDI is done as a greenfield investment (establishing a new firm), 2) among the real estate firms Sweden, Finland, Germany and Poland are the most important destinations for FDI, while in the Finnish sample of firms (including more manufacturing and service firms) St Petersburg, Poland, Estonia and Sweden are the most important destinations, 3) in the sample of real estate firms R&D and the proximity of the Russian market are not important motives for FDI, contrary to the Finnish, more manufacturing and retail trade-oriented sample, and 4) among the real estate firms the potential for large increases in real estate prices is an important motive for FDI.

Key words: Foreign direct investment (FDI), Baltic Sea Region, Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden, St Petersburg, Leningrad Region, Kaliningrad.

JEL-codes: F21, F23, F13, F15.

KOTILAINEN, Markku – **NIKULA**, Nuutti, **WHY DO FIRMS INVEST IN THE BALTIC SEA REGION? (MIKSI YRITYKSET INVESTOIVAT ITÄMEREN ALUEELLE?)** Helsinki: ETLA, Elinkeinoelämän Tutkimuslaitos, The Research Institute of the Finnish Economy, 2010, 36 s. (Keskusteluaiheita, Discussion Papers, ISSN 0781-6847; No. 1229).

TIIVISTELMÄ: Määrittelemme Itämeren alueen koostuvaksi seuraavista maista ja alueista: Tanska, Viro, Suomi, Saksa, Latvia, Liettua, Puola, Ruotsi sekä Pietari, Leningradin alue ja Kaliningrad. Tarkastelemme Itämeren alueen suoriin ulkomaisiin sijoituksiin vaikuttavia tekijöitä kolmesta näkökulmasta. Ensiksi, tutkimme teoreettisen ja empiirisen kirjallisuuden valossa suoriin sijoituksiin yleensä vaikuttavia tekijöitä. Toiseksi, selvitämme Itämeren alueen suorien sijoitusten maajakautumaa, rakennetta sekä muita sijoitusten tunnuspiirteitä. Kolmanneksi, tutkimme suoriin ulkomaisiin sijoituksiin Itämeren alueella vaikuttavia tekijöitä kahdella yrityskyselyllä: 1) MIPIM-kiinteistösijoitusmessuihin osallistuvien yritysten joukossa, ja 2) Itämeren alueella aktiivisten suomalaisyritysten keskuudessa (Finpro-rekisteri). Keskeiset yhteiset tulokset molemmista empiirisistä tutkimuksista ovat: 1) tärkeimmät suorien sijoitusten syyt ovat markkinoiden koko ja niiden kasvupotentiaali, 2) yritykset eivät näe Itämeren aluetta yhtenäisenä markkinana investointeja koskevassa päätöksenteossaan, 3) euroalueen ulkopuolella olevien maiden liittyminen siihen nähdään selvästi positiivisena asiana, mutta tulokset eivät ole kovin vahvoja: sitä voi selittää se, että osa valuutoista on jo melko uskottavasti kiinnitetty (Viro, Tanska, Latvia, Liettua) ja Ruotsin kruunun kellunta taas tuottaa yrityksille hajautushyötyjä, 4) julkisilla investointien edistämisorganisaatioilla on melko pieni merkitys varsinaisen investointipäätöksen teossa; ne ovat tärkeämpiä yleisen informaation antamisessa maan investointiolosuhteista. Suurimmat erot kyselyissä ovat seuraavat: 1) kiinteistöihin sijoittavissa yrityksissä pääosa sijoituksista tehdään ostamalla olemassa oleva yritys, suomalaisten Itämeren alueella aktiivisten yritysten joukossa suorat sijoitukset tehdään useimmiten ns. greenfield-sijoituksena (perustamalla uusi yritys tai toimipaikka), 2) kiinteistösijoitusyritysten joukossa Ruotsi, Suomi, Saksa ja Puola ovat tärkeimmät suorien sijoitusten kohdemaat; enemmän teollisuus- ja palveluyrityksiä sisältävän suomalaisten yritysten otoksen joukossa Pietari, Puola, Viro ja Ruotsi ovat tärkeimmät isäntämaat, 3) kiinteistösijoitusyrityksissä tutkimus- ja kehitystoiminta (t&k) sekä Venäjän markkinoiden läheisyys eivät ole merkittäviä syitä suorille sijoituksille; teollisuus- ja palveluyrityksistä koostuvassa suomalaisten yritysten joukossa ne taas ovat tärkeitä, 4) kiinteistösijoitusyrityksissä kiinteistöjen hintojen nousupotentiaali on merkittävä syy suorille sijoituksille.

Asiasanat: Ulkomaiset suorat sijoitukset, Itämeren alue, Tanska, Viro, Suomi, Saksa, Latvia, Liettua, Puola, Ruotsi, Pietari, Leningradin alue, Kaliningrad

JEL-koodit: F21, F23, F13, F15.

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1 Introduction

Foreign direct investment (FDI) contributes to the growth of the economies and to the increase in the welfare of the citizens. This is why governments, regions, cities and other public actors aim at attracting FDI to their areas. FDI is ultimately determined on the basis of profitability calculations of the firms. The time span of these depends on the size of the investment and on its reversibility. Usually the time horizon of an FDI project is long, and firms are willing to wait for the realization of their objectives.

The main driving factors of FDI are internal to the firm. The profit maximization situation of the firm depends, however, on its market situation and other external factors. When the internal or external conditions of the firm change, they may start thinking of investing in some other countries or regions.

In our project the focus is the FDI in the Baltic Sea Region (BSR), consisting of Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden, and the regions of St Petersburg, Leningrad Oblast and Kaliningrad in Russia. In this part of the study we will concentrate on the demand factors affecting FDI in these regions. This means the motives of firms to do FDI in general and in the BSR in particular. We cover the specific features of the BSR to some extent, but we do not, however, present or analyse these economies in detail. This will be done in another part of the project.

In the following chapter 2, we will first present a general framework on the motives of the firms for FDI. We will rely heavily on the eclectic (OLI) paradigm developed by John Dunning and his followers. The main reason for this choice is that it gives a synthesis and collection of several explanations and presents them in a unified form. This paradigm is based on theoretical as well as empirical literature. In addition to the motives of the firms, we also cover partially the host country determinants for FDI at a general level.

In chapter 3 we present some characteristics of the Baltic Sea Region from the point of view of FDI. These include the amount and sectoral composition of FDI, number of companies registered in the BSR countries, their turnover as well as values of existing indicators measuring the attractiveness of countries as host countries for FDI.

In chapter 4 we present the results of our firm questionnaires and analyse them. We directed the questionnaire to the firms participating in the MIPIM real estate fair and to Finnish firms active in the Baltic Sea region (Finpro register). Originally, it was our plan to direct the questionnaires to the participants of the MIPIM and to the participants of the Hanover Messe. We did not, however, succeed in obtaining the addresses of the relevant persons of the Hanover Messe firms and also in the case of MIPIM we had to guess the e-mail addresses, which may have reduced the number of answers. To compensate for this lack, we directed the questionnaire also to a sample of Finnish firms registered by Finpro as active in the different Baltic Sea countries. One of the advantages of this register is that the firms included in it are active in the BSR either through FDI or foreign trade. The other advantage is that the respondents are persons in charge for the operations of those firms in the BSR. The problem, of course, is the Finnish viewpoint in the answers. Most of the motives for FDI are, however, common to the firms irrespective of the country where they are registered.

In chapter 5 we summarise the results and present some conclusions.

2 Investment drivers: lessons from theoretical and empirical research

Profitability of a firm is an overriding driver for all investment, domestic and foreign. Investment is either replacement of an old facility or new net investment. The aim of the latter-mentioned is the growth of the firm. This in turn is estimated to be necessary to maintain or improve the profitability of the firm.

All factors that affect profitability are relevant for foreign direct investment (FDI). These factors can be divided into factors internal and external to the firm. Internal factors are related for example to the production, to the organization, and to several types of resources of the firm. External factors in turn cover the policies of the national, regional and city governments, general cost levels, logistics, actions of competing firms, etc.

Foreign direct investment is just one form of firms' foreign activities, which can be classified, for example, in the following way:

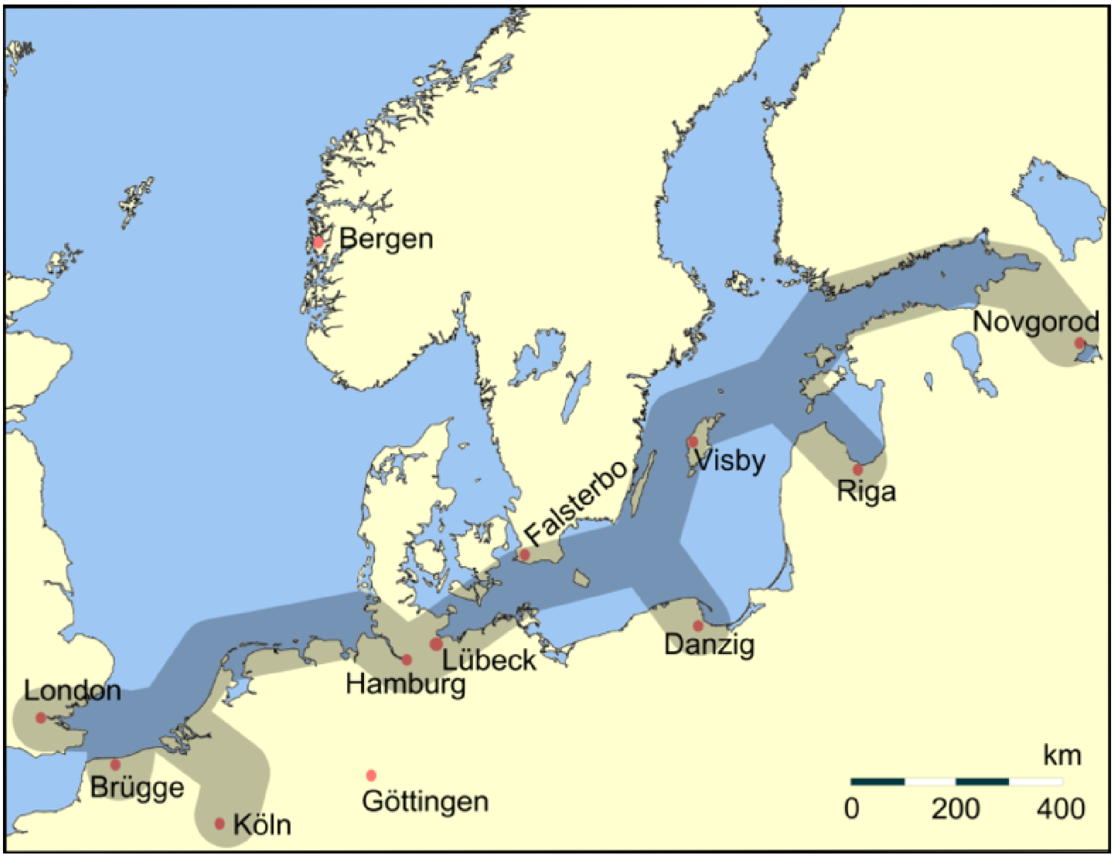
1) foreign trade of goods and services,
2) foreign direct investment (FDI),
3) other types of firm-level foreign activity and cooperation
   a. joint enterprises where the foreign owner has a minority share,
   b. supply of technology or trademarks in the form of licensing agreements,
   c. international subcontracting,
   d. franchising agreements,
   e. portfolio agreements
   f. use of foreign labour in the home country.

Foreign trade is the most traditional form of foreign operations. The Baltic Sea Region has been a site of intense foreign trade forseveral centuries. Actors of trade include the Vikings, the Hanseatic League etc. (See figure 2.1.)

In the case of foreign direct investment neighbouring countries located on the Baltic Sea have often been sources of investment. It is a common phenomenon that firms start their FDI activity in countries close to them geographically as well as culturally. In the Baltic Sea Region German firms have been active in many countries. Also Swedish firms have widened their presence especially in the Nordic and Baltic countries (excluding the Soviet period).

The branches of industry in which the FDI has been made has reflected the comparative advantages of the countries and regions as well as the supply conditions of those types of FDI. Often foreign production has been started by craftsmen who have learnt their profession in their home country and started to look for opportunities in other regions of the country or abroad. FDI has thus been closely related to foreign trade and migration. There has been a need for goods and services in some country and oversupply of them in some other country. Possibilities to earn have accordingly been better in the new host countries.

Figure 2.1 Main Trading Routes of Hansa



Source: Wikipedia.

A lot of the FDI stock in the Baltic Sea Region originates still from the neighbouring countries. New investment flows instead have a broader sample of home countries.

Also the motives for FDI have changed. Previously foreign direct investment was done in the whole production process. Nowadays investment can concentrate on a small part of the process. Other parts are done in countries where they can be done more profitably. A modern product includes components which originate in several countries. This is a part of the globalization phenomenon.

2.1 Motives for FDI

Dunning and Lundan (2008, 104-105) classify the foreign direct investment motives of firms as follows:

1) Natural resource seeking,
2) Market seeking,
3) Efficiency seeking
   a. of products
   b. of processes
4) Strategic asset seeking.

The above classification is not always exclusive. FDI can represent several motives at the same time. The classification should also be regarded more as a thinking framework than as the final truth. Motives of FDI also change and this creates a need for continuous rethinking.

Natural resource seeking firms want to produce high quality products at low cost. They seek:

a) physical resources,
b) cheap and skilled labour,
c) technological capability, management or marketing expertise, organizational skills.

Physical resources include mineral fuels, industrial minerals, metals, agricultural products and other types of location bound resources in tourism, the real estate business, transportation, medical and educational services, etc. Usually the firms are specialized in the production of these types of products and FDI is their way of growing behind the boundaries of one country. Often the firms are multinationals which operate globally or in some macro-region like the Baltic Sea Region. One example is the Finnish energy company Fortum, which defines its home market as consisting of the BSR and Russia.

Labour is a crucial resource in any production. In low-skill work the price of labour dominates. In jobs which require high skills the quality of labour is more important. Always their combination is the crucial criterion. Around the Baltic Sea cost levels differ a lot. They are lower in Russia, in Poland and in the Baltic states than in the Nordic countries and Germany. These differences direct also FDI inside the BSR. None of the BSR countries is, however, currently predominantly a low-cost country. Other investment motives are also important.

Technological capacity, management or marketing expertise and organizational skills are also resources that are attraction factors for FDI. A high technological level of a country has recently been an important attraction, for example, for Chinese FDI. The affluent Chinese capital is invested, for example, in the production of Volvo cars. The investors aim at a high technological level as well as a well-known brand.

Market seekers are often strong exporters that try to avoid obstacles to trade (transport costs and high trade barriers), but also firms which have produced home market goods in low-growth product categories (like several types of services, construction, foodstuffs). The size and growth of the market as well as the level of saturation of the market in the products in question are important variables for these kinds of firms. For example, before the Eastern enlargement of the EU in 2004, Finnish firms saw the growth potential of these markets as the most important attraction for FDI (Alho, Kaitila and Kotilainen, 2004). In the Baltic Sea Region a relevant example of a market seeking motive is that of the Nordic banks (Nordea, SEB and Swedbank). They have widened their activity in the Nordic and Baltic countries as well as in Poland.

In addition to general market size and growth factors, there are some special reasons for market seeking FDI (Dunning and Lundan, 2008, 70-71). If main <u>suppliers or main customers</u> are concentrated on some market, the firms need to have a local presence there. This is the case for Japanese car manufacturers in the USA. They were obliged to start production there to get a stronger foothold in the market. For Nokia the Chinese market is very important and it had to start production there (also low wage costs affected this decision). For logistical and cost reasons, also Nokia's subcontractors soon followed.

The Nokia case is relevant also with respect to another market seeking motive, namely the need to adapt the product better to the local market. In mobile phones this pertains to the Chinese language, tastes, business customs, legal requirements, etc.

Also production and servicing costs are often lower when the firm is established in the market where the products are used. The size of this benefit depends on the obstacles to trade and on several types of government regulations. In principle, these kinds of obstacles should be small between the EU countries, but in practice they still exist. In the Baltic Sea context they are the most important in the case of Russian regions for EU firms. For non-EU firms there are trade obstacles and differing regulations and standards also in the EU countries. If transport costs are small and economies of scale are large, firms are tempted to favour exports. In the opposite case they favor FDI.

The presence of competitors in the market in question matters, too. If firms gain from the local presence, they improve their relative competitive position by investing there. Often it is not a question of direct costs, but also a matter of a positive image in the eyes of the locals, who appreciate a local presence and production. This type of investment can be either aggressive (first move) or defensive (follower or bandwagon type).

Host countries can affect the market seeking investment by imposing or relaxing trade barriers and regulations. One example of this is the export duties for raw wood which the Russian government increased in order to attract FDI in the forest industry. Several types of tax concessions and free trade zones are in turn “carrot” type measures to attract FDI to the country. Additionally, bilateral investment agreements are used as a means to promote FDI.

Dunning and Lundan (2008, 71) estimate that about 40 per cent of the FDI stock at the end of the 1990s can be classified as market seeking. In the case of developing and transition countries this share was even 60 per cent.

Efficiency seeking firms gain from common administration of geographically dispersed activities. These kinds of firms want to optimize their activities between different countries locating them where they earn the highest profit (or some other related target) for the whole company. The firms balance between the benefits of economies of scale and scope received from one location and diversification benefits of several locations (related costs and risks). The firms can locate their products or processes according to the characteristics of countries, arbitrage cost and price differentials, take advantage of different factor endowments, cultures, institutional arrangements, demand patterns, economic policies, market structures, exchange rates, etc. (see ibid, 72). These kinds of diversification benefits can be obtained, for example, by producing labour-intensive parts of the product in low cost-countries, and skill-intensive parts in advanced (but high-wage) countries. Also differences in consumer tastes or supply capabilities can be criteria for diversification.

Efficiency seeking firms represent a globalised (modern) type of production where production of a product is no longer located according to the comparative advantages of countries, but instead, different processes are located according to several country-specific competitive advantages. Many of these are “self-created” and not determined by physical resources.

Strategic asset seekers are firms that engage in FDI to promote their long-term strategic objectives. They want to strengthen their long-term competitive position in the market. Above all they try to acquire a global portfolio of physical assets and human competences, rather than just exploit specific cost or marketing advantages. With this portfolio of assets the firms want to sustain or improve their ownership-specific advantages or weaken those of their competitors.

One group of strategic asset seekers is strong firms originating from emerging market countries. Examples of these are Chinese investment in IBM and Volvo as well as Indian investment in the steel industry. They have bought competitive strength and know- how in markets which were previously unfamiliar to them.

Strategic asset seekers have several types of motives for their FDI, like:

- opening up new markets
- creating R&D synergies or production economies
- buying market power
- lowering transaction costs
- assessing new organizational skills
- spreading administrative overheads
- advancing strategic flexibility
- enabling risks to be better diversified (See Dunning and Lundan, 2008, 73.)

To achieve these targets, firms can also use other types of firm-level cooperation forms, like strategic alliances.

In principle a direct investment requires some active involvement in the activity of a firm, whereas *a portfolio investment* is fully passive. In some cases, however, it is difficult to make a distinction between a portfolio and a direct investment. Especially investment bankers can invest in a company and own it for a long time. They are, however, often more footloose owners than a firm operating in the same sector as the target firm. In the case of real estate investment the portfolio and direct investment motives can also be mixed, because an expectation of changes in real estate prices is certainly an important dimension, in addition to running a real estate business in some country.

2.2 Theories of location and FDI

Currently there are two dominating groups of theories for the determination of FDI: 1) those of the international business discipline and 2) those of the economics profession.

In the former group the “eclectic” or OLI (O=ownership, L=location, I=internalization) paradigm developed by John Dunning and his followers is the most well known. It has incorporated several partial theories into a common framework. (See Dunning and Lundan, 2008.) The so-called new economic geography theory developed by Krugman, Fujita, Venables etc. puts much emphasis on the national and regional demand potential as a the determinant for production and investment. (See Krugman, 1992, and Fujita et al, 2002.) These two approaches are complementary to each other. To some extent the former one has tried to incorporate general elements of the latter one into it, but the work is still very incomplete.

<u>The OLI paradigm</u> classifies the main factors affecting FDI (or international production) into three main groups: 1) ownership, 2) location and 3) internalisation-related factors. Each of these groups consists of several sub factors. (See Dunning and Lundan, 2008, 101.)

Ownership-specific advantages (O) of an enterprise of one nationality (or affiliates of the same) over those of another consist of i) property rights and/or intangible asset advantages (Oa), ii) advantages of common governance (organizing Oa with complementary assets) (Ot), and iii) institutional assets (Oi).

The "property rights and/or intangible assets" subcategory includes the asset structure of the firm, product innovations, production management, organizational and marketing systems, innovatory capacity, noncodifiable knowledge, accumulated experience in marketing, finance,etc.

The common governance subcategory consists of two lower-level categories: firstly, of those advantages that branch plants of established enterprises may enjoy over new firms (these are related to size, product diversity etc.), and secondly, advantages which specifically arise because of multi-nationality. This means, for example, operational flexibility by offering wider opportunities for arbitraging, production shifting and global sourcing of inputs.

The institutional assets (Oi) subcategory includes the formal and informal institutions that govern the value-added processes within the firm, and between the firm and its stakeholders, codes of conduct, norms and corporate cultures, incentive systems, leadership and management diversity.

Location-specific factors (L) include spatial distribution of natural and created resource endowments and markets, input prices, quality and productivity (e.g. labour, energy, materials, components, semifinished goods, international transport and communication costs, investment incentives and disincentives, import and export controls of goods and services, infrastructure provisions (education, transport, communication) as well as cross-country ideological, language, cultural, business and political differences, economies of agglomeration and spillovers, the economic system and strategies of government, the institutional framework for resource allocation and legal and regulatory systems.

Internalisation advantages (I) include avoiding search and negotiating costs, moral hazard and adverse selection costs and costs related to broken contracts and reducing buyer uncertainty about nature and the value of inputs. It also includes the need of the seller to protect the quality of intermediate or final products, capture economies of interdependent activities, compensate for the absence of future markets, avoid or exploit government intervention (quotas, tariffs, price controls, tax differences, etc.), control supplies and conditions of the sale of inputs (including technology), control market outlets, the possibility to engage in practices, such as cross-subsidisation, predatory pricing, leads and lags, and transfer pricing as a competitive (or anticompetitive strategy).

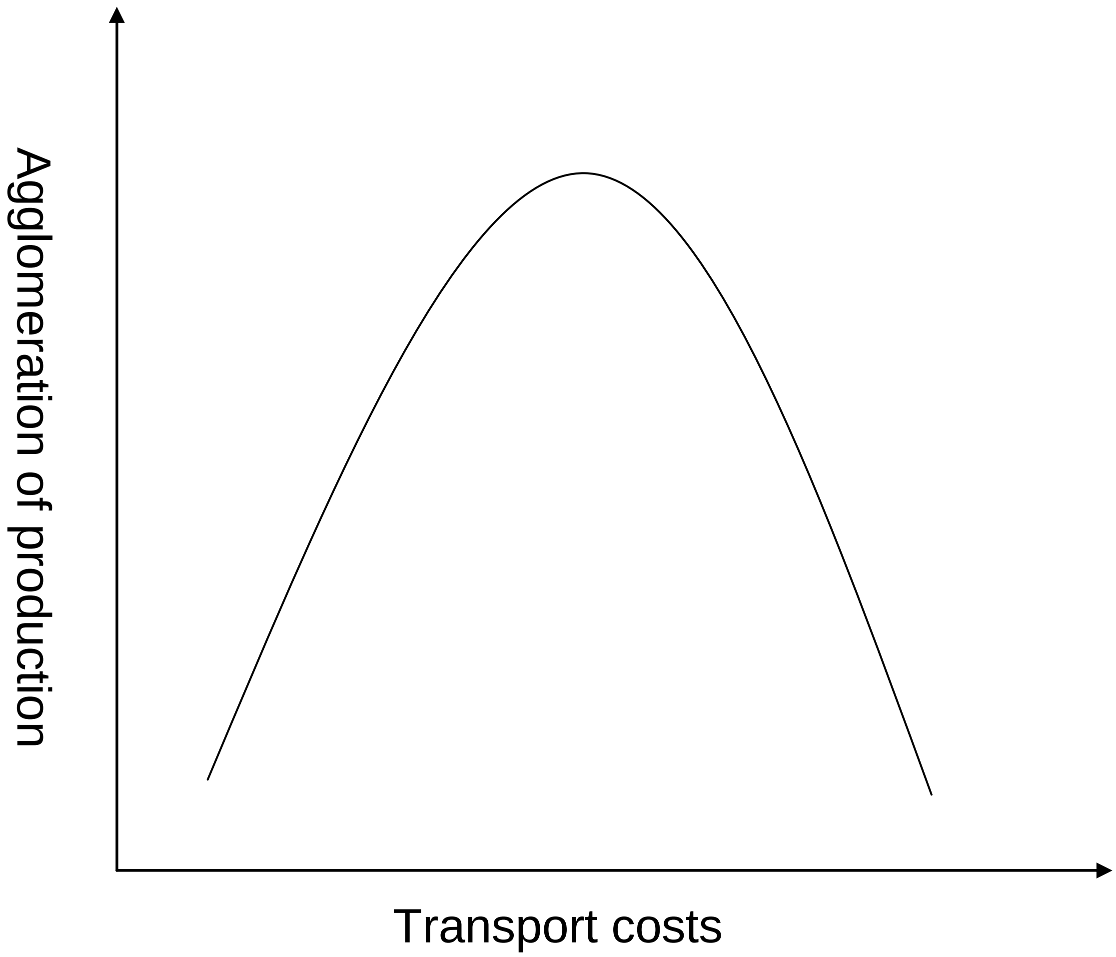
From the point of view of the Baltic Sea Region, the location-specific factors are naturally the most evident. The other factors, however, are also important when they combine with each other and with the local specific factors.

<u>The new economic geography theory</u> aims at explaining the location of production between different countries and regions. The crucial trade-off for firms is between producing in some location and exporting products there. The new economic geography approach does not exclude traditional comparative advantage as an explanation for trade and investment but it is an important complement to it. A large part of location decisions between countries is still

based on comparative advantage. Specialization according to comparative advantage means concentration on those types of products, the production of which is relatively most advantageous (profitable) in that country.[1] The new economic geography theory explains the existence of the so-called intra-industry trade, which comparative advantage does not cover. The new economic geography approach is extensively used when explaining location between regions inside certain countries.

An important determinant for agglomeration of production is the level of transport costs (Figure 2.2.). This trade-off follows an inverse U shaped form. Production is dispersed when transport costs are low: products can easily be exported. When they gradually increase, production starts to concentrate to fewer locations. At the other end of the spectrum, when production costs are very high, the production is again dispersed and ultimately there is an autarky. The effects of transport costs are combined with the effects of imperfect competition, economies of scale as well as with the mobility of factors of production and intermediate products.

Figure 2.2 Agglomeration of production as a function of transport costs



Increasing economies of scale mean that production is more efficient in large production units. Without scale economies production could occur in small units. Low transport costs in turn limit the agglomeration of production, because they enable deliveries of products to

[1] Foreign trade theories based on comparative advantage are not surveyed here, because they are rather well known and because their basic idea can easily be explained and understood.

customers living at long distances. On the other hand, production tends to agglomerate in areas where average transporting costs are low. This is the case in big cities and in regions with logistically favourable routes. Production requires also labour resources, which are competent and favourable enough. In each type of production there is an optimal combination of these features. A big and efficient market lowers prices and attracts labour to those locations. In addition to efficiency of the labour market, also efficiency of the intermediate product market is important.

When choosing between different locations, the market potential of each location is crucial. Market potential can be measured with several units of measure, but generally speaking it can be understood as the attractiveness of each location. Also the profits of firms are the highest in the areas of high market potential.

Traditionally location decisions have been analysed at the level of finished products. The so-called new paradigm of globalization stresses that nowadays different locations tend to specialize in different phases of production. This phenomenon is called the second unbundling of production. Some parts of the product are produced in one country and other parts in other countries. This concerns also several types of services that are required in the production, like call centres, bookkeeping for accounts payable and receivable, and office services. (See Baldwin, 2006, and references in it.)

From the point of view of the Baltic Sea Region all the above-mentioned factors explaining location/investment decisions are relevant. Firms widen their production to foreign countries if local production is more profitable than exporting there. Production sites in turn are chosen on the basis of the attractiveness of those sites. The attractiveness depends on the size of the market, on the availability of qualified but cheap labour, on the effectiveness of transport connections etc. Foreign direct investment is often made in some activities, like production of some part of the product or doing some service. In several cases the investing firms originate from the other Baltic Sea countries. In this case the physical and cultural proximity of the countries/regions as well as the effectiveness of transport and communication is important.

2.3 Host country determinants of FDI

Some of the determinants of the location are physical, some are intangible. Some are market-based, some are related to the political decisions of national or local authorities.

Dunning (2006) classifies the host country determinants applying them to the OLI paradigm as follows: 1) general policy framework, 2) policies specific to FDI and 3) economic determinants by type of investment. They each consist of several subcategories.

1 The general policy framework

- economic, political and social stability
- good governance (transparent and credible policies and their enforcement)
- policies on functioning and structure of markets, especially competition and mergers & acquisition (M&A) policies
- private property protection (including intellectual property rights, IPRs)
- industrial and regional policies; development of competitive clusters
- trade policy (tariffs and non-tariff barriers) and stable exchange rates

2 Policies specific to FDI

- bilateral international investment agreements (IIAs)
- investment incentives and performance requirements (pre- and post-entry)
- pre- and post-investment services (e.g. one-stop shopping)
- social amenities (international schools, quality of life etc.)

3 Economic determinants by type of investment

a) Market-seeking investment
- market size and per capita income
- market growth
- country-specific consumer preferences
- structure of markets
- psychic distance
- access to regional and global markets

b) Resource-seeking investment
- land and building costs: rents and rates
- cost of raw materials
- low-cost unskilled labour
- availability and cost of skilled labour

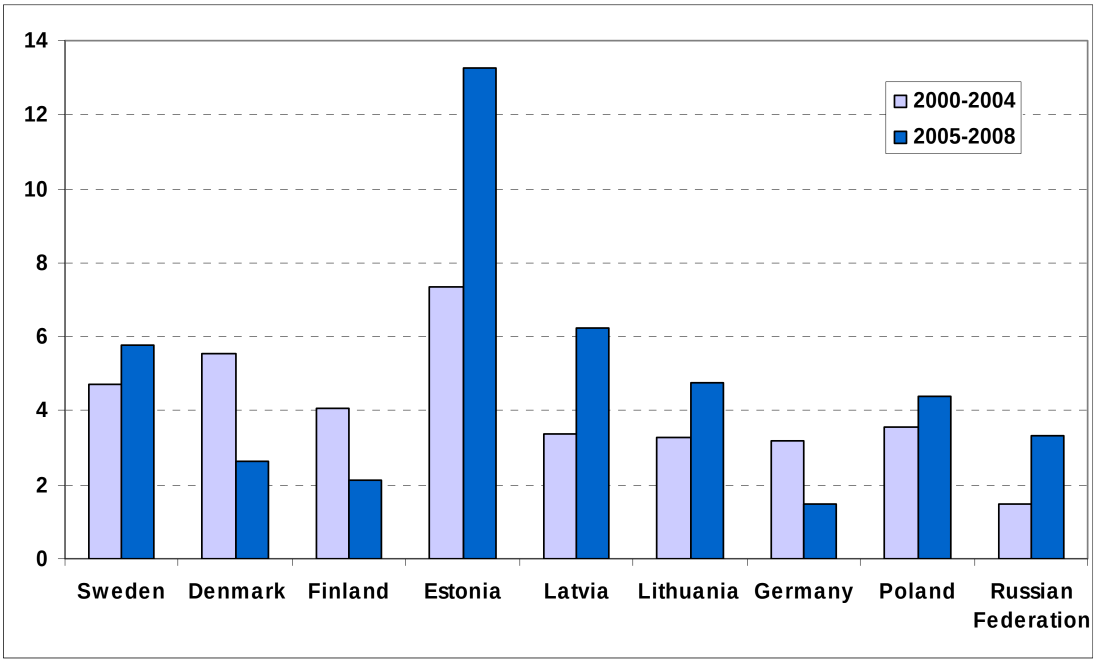
c) Efficiency-seeking investment
- costs of resources and capabilities listed under (b) adjusted for productivity of labour inputs
- other input costs, e.g. transport and communication costs to, from and within host economy
- membership of a regional agreement conducive to promoting a more cost-effective inter-country division of labour
- quality of market-facilitating institutions

d) Asset-seeking/asset-augmenting investment
- competition policy (including M&As)
- technological, managerial, relational and other created assets
- physical infrastructure (ports, roads, power, telecommunications)
- macro-innovatory, entrepreneurial and educational capacity/environment.

3 Characteristics of the Baltic Sea Region

Figure 3.1 shows that in the period of 2000 – 2004 all the BSR countries received rather similar amounts of FDI as a proportion of GDP. Russia's economy is notoriously difficult for foreign investors, which explains why it did not receive more investment. On the other hand, Estonia has done a lot to lure foreign investment and it was the biggest recipient in 2000 – 2004. Nordic economies that have a good and stable economic environment were able to get an amount of FDI that is over four per cent of their GDP. Germany's rather low figures can at least partially be explained through its big size and its capital richness.

Figure 3.1 Foreign direct investment to the BSR, net inflows (% of GDP)



Source: World Bank.

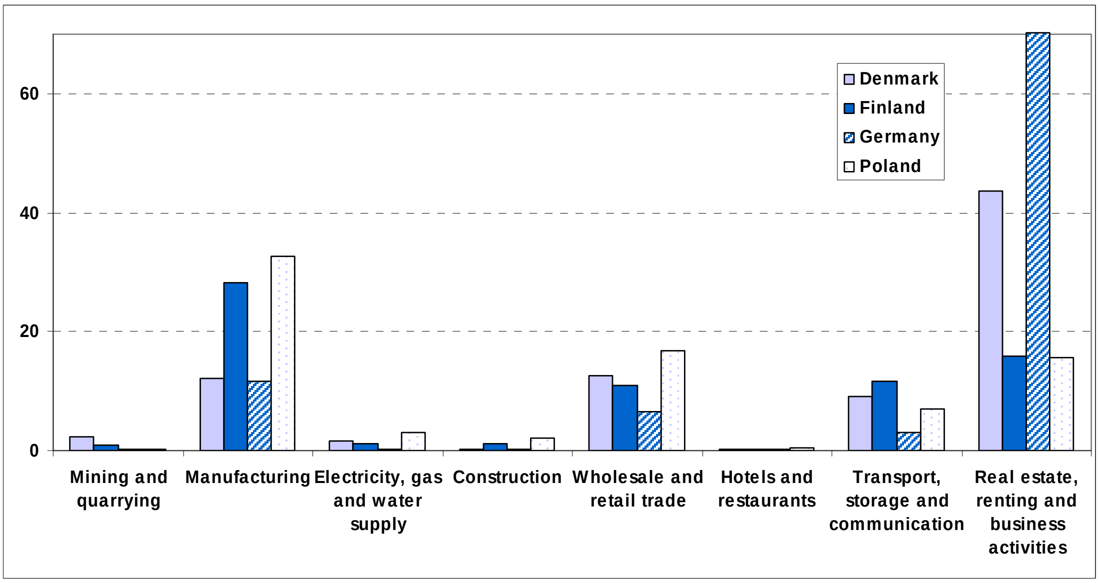
In 2005 – 2008 the Baltic countries got a lot of FDI. This is because their economies grew at a fast pace. Estonia's relative FDI gains were more than double what they were in the other Baltic countries. Also Poland strengthened its position in the eyes of foreign investors. Nordic countries and Germany were unable to get as much FDI as in the previous period. Sweden was an exception as it improved its situation from the previous period.

In Figure 3.2 we look how FDI is distributed in different sectors of the economy. Data about this is somewhat weak because not all countries collect this information.

From the figure we can see that in Denmark and Germany the majority of FDI goes to real estate and business activities sectors. In Finland and Poland investment to manufacturing is bigger. This is because the structures of their economies are different.

These two sectors as well as the wholesale and retail trade sector are by far the biggest recipients of FDI in this group of countries. Combined they account for almost 70 per cent of the countries' FDI.

Figure 3.2 Foreign direct investment to the BSR for different sectors of economy, net inflows (% total FDI) 2006 - 2008



Source: OECD.

Table 3.1 Number of enterprises in the BSR, per cent of enterprises registered in EU countries

	Sweden	Denmark	Finland	Estonia	Latvia	Lithuania	Germany	Poland	BSR
Mining and quarrying	2.9	0.8	4.6	0.4	0.7	0.4	9.2	6.8	25.8
Manufacturing	2.6	0.8	1.1	0.3	0.3	0.7	8.7	8.5	23.0
Electricity, gas and water supply	4.2	10.2	3.6	0.7	0.8	0.8	9.3	5.9	35.7
Construction	2.4	1.2	1.3	0.2	0.2	0.6	6.6	6.6	19.1
Wholesale and retail trade	2.0	0.8	0.8	0.2	0.4	0.9	7.5	9.1	21.6
Hotels and restaurants	1.5	0.8	0.6	0.1	0.2	0.2	10.7	3.3	17.5
Transport, storage and communication	2.6	1.2	2.0	0.3	0.5	0.7	7.9	12.2	27.4
Real estate, renting and business activities	3.9	1.3	1.0	0.3	0.4	0.5	10.4	4.8	22.6
All	2.7	1.0	1.0	0.2	0.3	0.7	8.6	7.1	21.7

Source: Eurostat.

In Table 3.1 we see how big a share of EU enterprises is registered in BSR countries (excluding Russia). Table 3.1 shows that on average almost a quarter of the EU's business enterprises are located in BSR countries. This is mostly because of Germany's dominant role in the EU. Of course only a part of German firms are active near the Baltic Sea.

The turnover of companies in high-income BSR countries is higher than in the rest of the EU. From Table 3.2 we can see that the turnover in companies located in Denmark, Finland and Germany is on average bigger than in the rest of the EU. Almost 30 per cent of the combined turnover of EU's business enterprises comes from BSR.

Higher turnover and higher productivity mean tougher competition and it makes the investment riskier. On the other hand, companies in the Baltic countries and Poland have relatively lower turnover than in the rest of EU, which means that they can offer interesting investing opportunities.

Table 3.2 Turnover of companies in BSR, percentage of EU enterprises' total turnover

	Sweden	Denmark	Finland	Estonia	Latvia	Lithuania	Germany	Poland	BSR
Mining and quarrying	1.3	3.6	0.5	0.1	0.1	0.1	6.2	4.4	16.4
Manufacturing	2.8	1.3	2.1	0.1	0.1	0.2	25.8	3.2	35.6
Electricity, gas and water supply	2.3	1.8	1.1	0.1	0.2	0.2	29.9	3.6	39.1
Construction	2.6	1.9	1.4	0.3	0.3	0.3	9.2	2.7	18.8
Wholesale and retail trade	2.5	2.2	1.4	0.2	0.3	0.3	15.9	3.2	25.9
Hotels and restaurants	2.1	1.3	1.1	0.1	0.1	0.1	11.2	1.2	17.3
Transport, storage and communication	3.3	3.1	1.5	0.3	0.3	0.3	17.0	2.5	28.2
Real estate, renting and business activities	3.4	2.0	1.1	0.1	0.1	0.1	16.3	1.6	24.8
All	2.7	1.9	1.5	0.2	0.2	0.2	19.0	2.9	28.7

Source: Eurostat.

Table 3.3 shows the shares of the companies in different BSR countries that are multinationals. We also see that foreign ownership is bigger in manufacturing than in the economy as a whole.

Table 3.3 Multinational companies' share of employees in BSR, 2006

	Total Business Enterprise	Manufacturing
Sweden	23.6	34.3
Denmark	18.3	21.2
Finland	13.5	17.8
Germany		16.5
Poland	22.2	30.9

Source: OECD.

Table 3.4 Multinational companies' share of turnover in the BSR in 2006

	Total Business Enterprise	Manufacturing
Sweden	33.1	41.7
Denmark	21.8	23.8
Finland	18.7	16.2
Germany		29.6
Poland	34.3	45.5

Source: OECD.

Table 3.3 also shows that foreign ownership is larger in Sweden and Poland than in Finland and Germany. In Poland this can be explained by the fact that as a relatively low-income but fast growing country it has been a tempting place for foreign investors. In Sweden's case it is possible that foreign companies are using Sweden as their home country for all Nordic operations. It also reflects the fact that some big formerly Swedish companies like ABB are currently registered abroad.

Multinational companies in the BSR produce more turnover per employee than domestic companies. For example, 22 per cent of Polish companies' employment is in multinationals (table 3.3) but they produce 34 per cent of turnover. This means that multinational companies are more productive than domestic companies. This shows how FDI improves countries' economic performance. Big multinational companies usually contribute to more economic activity and to better living standards. This is why countries are doing their best to lure foreign investors.

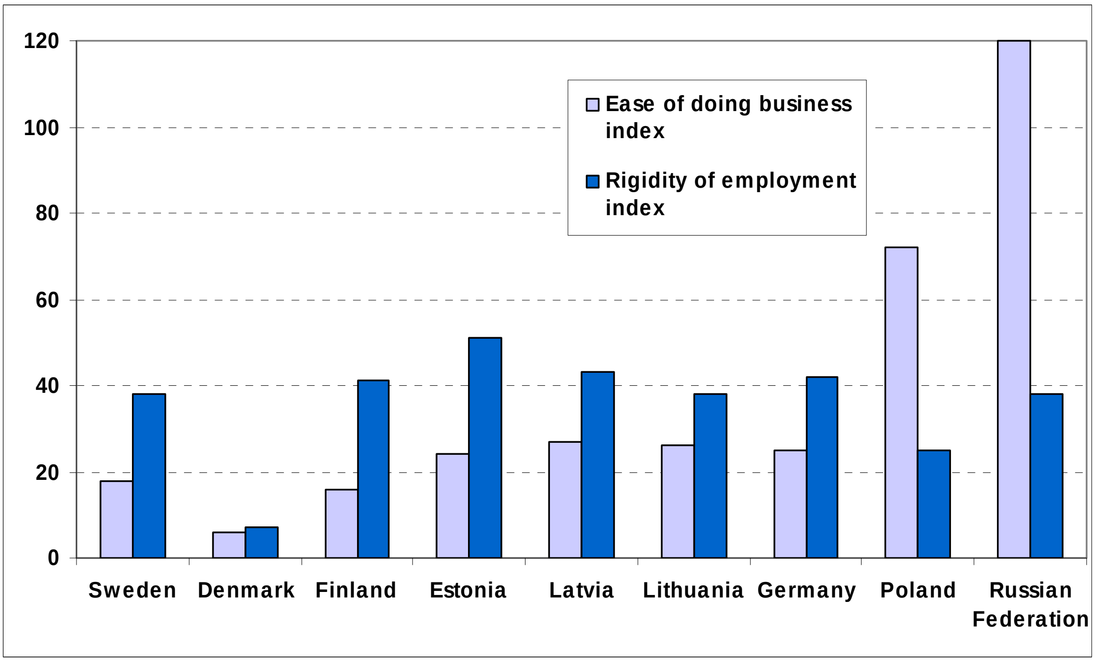
Table 3.5 Percentage of how much more productive employees in multinational companies were in BSR (turnover per employee) in 2006, compared to domestic companies, %

	Total Business Enterprise	Manufacturing
Sweden	40.3	21.6
Denmark	19.1	12.3
Finland	38.5	-9.0
Germany		79.4
Poland	54.5	47.2

Source: OECD.

Table 3.5 combines tables 3.3 and 3.4. It shows the productivity difference between foreign owned and domestic companies in percentages. For example, the productivity difference in Sweden is over 40 per cent in favour of the multinationals. The only case where domestic companies are more productive is manufacturing in Finland. This is probably because one domestic company, Nokia, has been so productive in the Finnish economy.

Figure 3.3 "Ease of doing business" and "employment rigidity" indexes in BSR, (1=most business friendly regulations)



Source: World Bank.

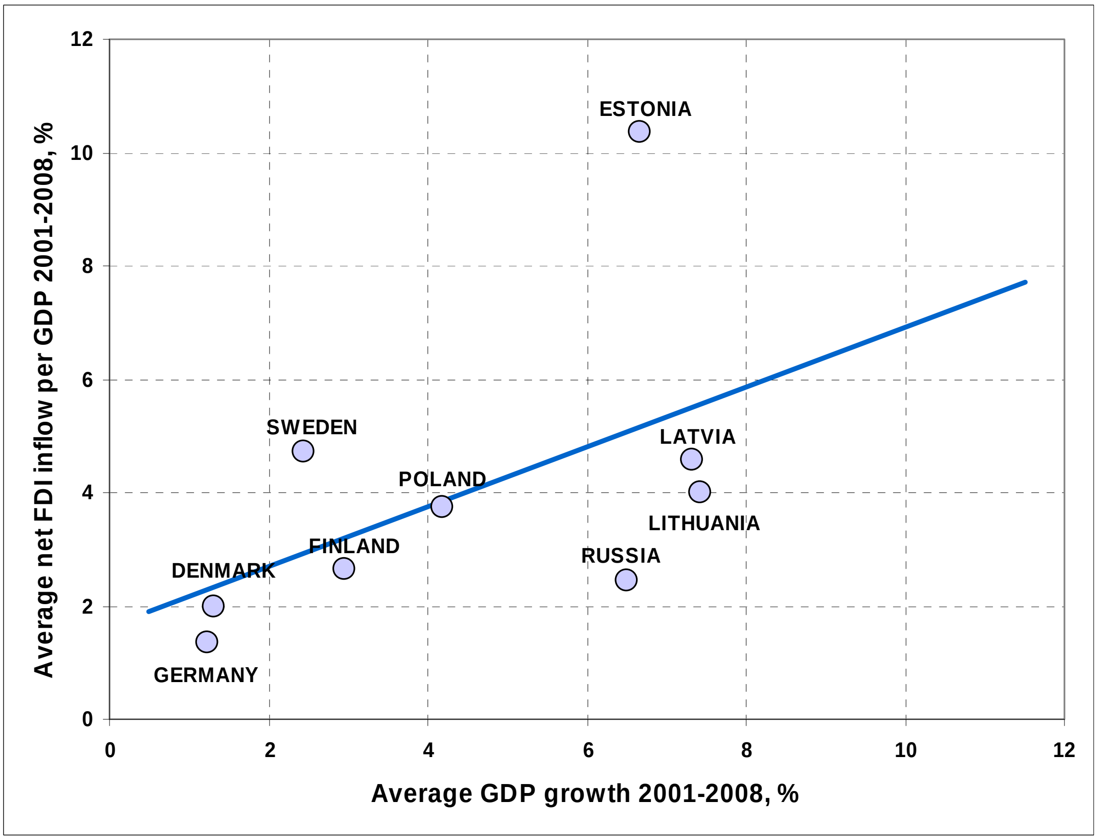
In Germany multinational companies in the manufacturing sector are almost 80 per cent more productive than domestic companies. This is somewhat unexpected as Germany is normally thought to be one of world's leading industrial countries. Reasons why foreign companies are normally more productive than domestic ones are that they are bigger and that it is usually easier for them to lay off unnecessary employees. Hard economic decisions are easier to make when companies are not so connected to their host countries. Higher productivity can also be explained by sector-specific differences. Multinationals often operate in high productivity sectors.

Most countries understand how important foreign investors are for countries' economic well being. They thus try to make the economic conditions for them as good as they can. Figure 3.3 shows two different indexes of how well BSR countries have performed in this task. The "Ease of doing business" index measures legal, tax and other conditions of entrepreneurs.

We see that the best place to do business is Denmark and the hardest place is Russia. Bureaucracy and illegal activities in Russia have made it a difficult place for investors to succeed. Poland suffers from the same difficulties. In other BSR countries conditions are better and it is easier for them to attract foreign investment.

The "Rigidity of employment" index measures how hard it is for companies to deal with labour issues. Many European countries try to protect employees so much that it makes it risky for companies to hire people in the first place. Complex labour laws make countries more unattractive for foreign investors. Figure 3.3 shows that in Denmark and Poland labour laws are the most attractive of all BSR countries.

Figure 3.4 Link between economic growth and foreign direct investment



Source: World Bank and IMF.

The indexes presented in Figure 3.3 have some correlation with the amount of FDI which different countries are receiving. The best way to attract FDI is, however, strong economic growth. Figure 3.4 shows the linkage between FDI and economic growth. We can see that in countries where economic growth has been fast, also FDI has been high. The causality between these variables certainly goes in both directions.

Economic growth is usually fastest in the countries where the level of economic well-being is low. Poorer countries can copy innovations and technology that other countries have invented. There is a catching up process that normally means fast economic growth. Fast economic growth can mean bigger than normal profits for companies so they are interested in investing in relatively poor countries. This can be seen in the Baltic countries where FDI is at a higher level in relative terms than in the Nordic countries.

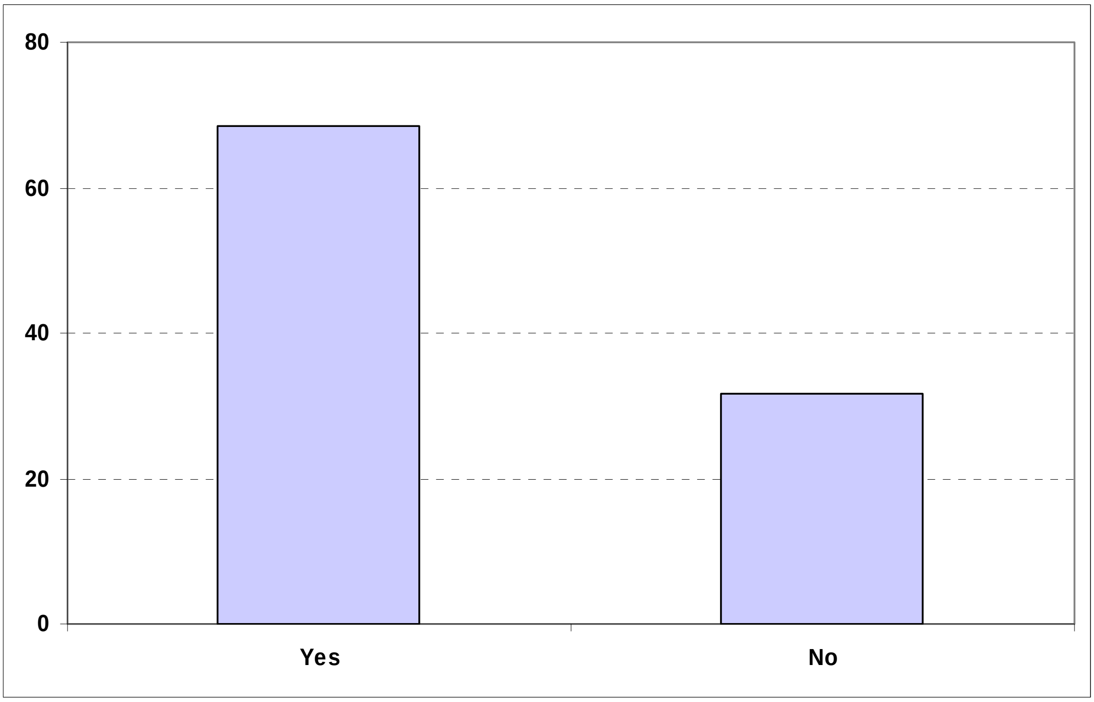
4 Results of the firm questionnaire

In order to deepen our understanding of investment decisions and motives we have performed two enquiries of companies. Both enquiries were conducted by sending an e-mail link to an electronic questionnaire. The first enquiry was sent to international companies that participated in the MIPIM real estate fair and the other enquiry was sent to Finnish companies that operate in the BSR.[2] The questions are presented in the annex.

4. 1 Real estate firms (MIPIM register)

MIPIM is an annual real estate fair that advertises itself as the world's biggest event in its field. We were able to get the participant list and we sent a link to an internet questionnaire. The companies that participate in MIPIM are mainly real estate firms. Investment decisions in these sorts of companies are different from those in manufacturing companies. The results must thus be interpreted keeping this background in mind.

Figure 4.1 Does your company have foreign direct investment (FDI) or do you intend to invest in the next 5 years in Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden or St Petersburg, Leningrad region and Kaliningrad? (Results presented in percentages)



Over 60 per cent of the companies that answered have some business in the BSR. This is a fairly expected result. For example, the real estate market in Germany is one of the biggest in Europe so it is natural that large international real estate companies own property there.

[2] Our initial aim was to direct the questionnaire to firms participating in the Hannover Messe, too, but we did not succeed in having the e-mail addresses of the relevant persons in those firms (see Chapter 1).

Figure 4.2 Please indicate in which countries you have made and are planning to make investment (results presented as percentages)

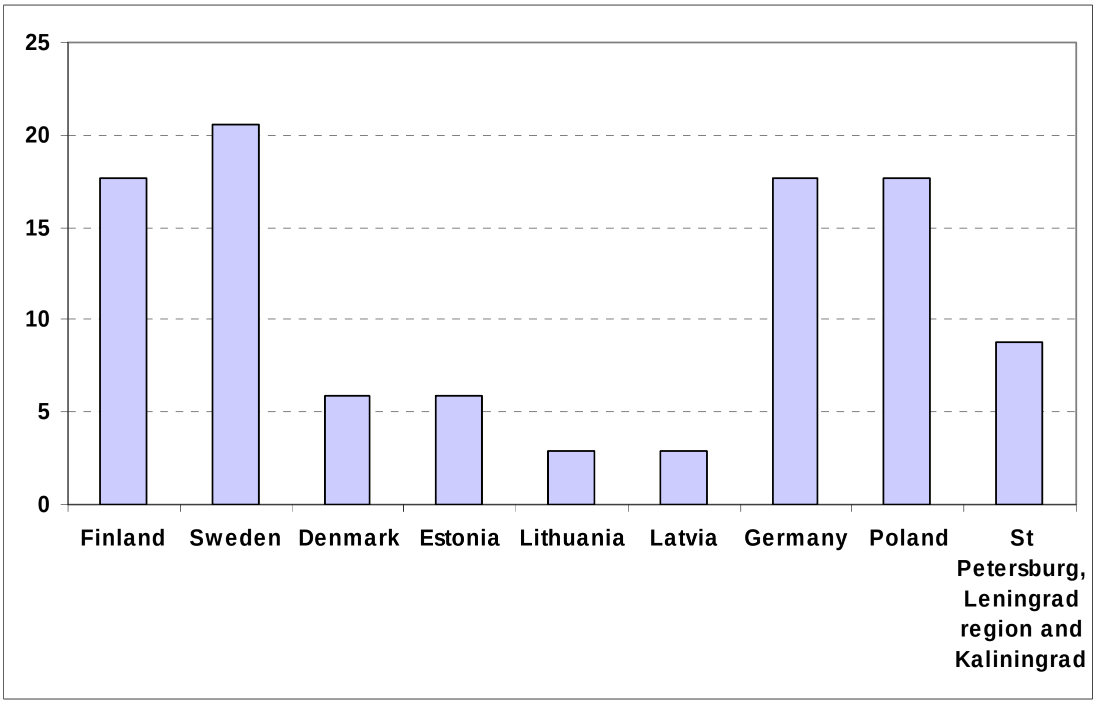
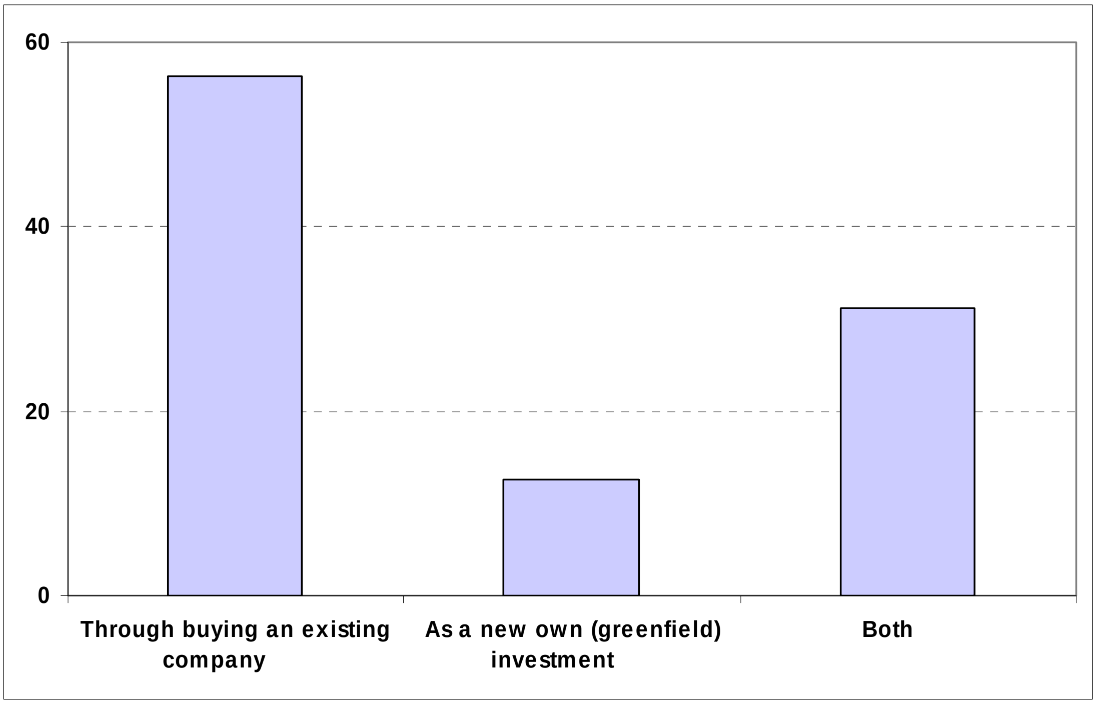


Figure 4.3 Are the investments made…? (results presented in percentages)



From Figure 4.2 we see that the majority of investment is made in high-income BSR countries. Finland, Sweden and Germany constitute over 50 per cent of the reported FDI. Another bigger group is the St Petersburg area and Poland. Economic growth in these areas is fast so there is a possibility to make large profits. FDI in the Baltic countries is at a lower level in absolute terms than in the other BSR countries. This can be explained by their smaller size. On the other hand, they have experienced fast economic growth so the results are somewhat unexpected.

Although most respondents operate in the real estate sector, some companies that answered also have production and support activities in the BSR. Some have jointly owned companies in the St Petersburg area and in Germany. In the case of the companies that have businesses in Russia this is partly explained by the high level of bureaucracy. It is wise to align with domestic companies if economic conditions in a country are unreliable.

Figure 4.3 shows that almost 60 per cent of the foreign direct investment is made by buying an existing company. Only a little over 10 per cent of the investment is done as a completely new company. About a third of the investments are a combination of these two.

We asked companies' opinion about different investment promotion agencies. Almost all respondents said that these kinds of agencies have at best a very small role. Only in Estonia has the national investment promotion agency had some impact. Companies are used to collecting their own data and other information and then they base their investment decisions on that.

Respondents received less than 20 per cent of their turnover from BSR countries. This is expected because we sent our questionnaire to large multinational companies. These sorts of companies have businesses all over the world so it is natural that they are not very dependent on one market.

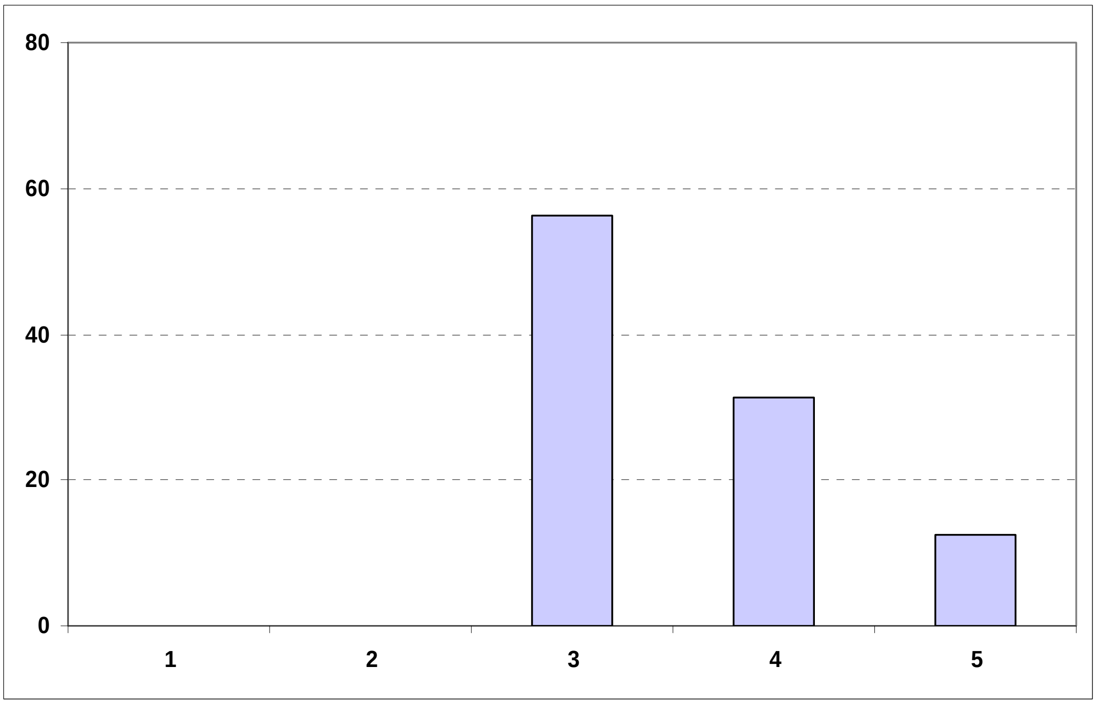
Table 4.1 Please indicate in which of the countries the following motivations were/are SIGNIFICANT factors in making investments (results presented in percentages)

	Nordic countries	Baltic countries	Germany and Poland	St Petersburg, Leningrad region and Kaliningrad	All
Size of the market	1.3		5.1	2.6	9.0
Growth potential of the market	1.3	2.6	2.6	3.8	10.3
Strategic location with respect to marketing	1.3	2.6	2.6	2.6	9.0
Strategic location with respect to materials and /or production	1.3	2.6	2.6	1.3	7.7
Easy access (air, sea and land)	1.3	2.6	2.6	2.6	9.0
Beneficial labour costs		2.6	1.3	1.3	5.1
Beneficial taxation		2.6		1.3	3.8
Educated labour force	1.3	2.6	1.3		5.1
High R&D level and its availability in the host country	1.3	1.3			2.6
Availability of support services		1.3			1.3
Good infrastructure	3.8		3.8		7.7
Good living conditions and related services	2.6		2.6		5.1
Stability of the economy	5.1		5.1		10.3
Proximity of the Russian market				3.8	3.8
High increase potential of the real estate prices	1.3	2.6	2.6	3.8	10.3
All	21.8	23.1	32.1	23.1	

From Table 4.1 we see that the most important motives for investment in the BSR are economic stability and growth. A big market can also contribute to big profits. Because our respondents operate in the real estate sector, they are not very interested in things like high R&D level or educated labour force.

Germany and Poland represent the most interesting markets. This is explained by their large size. Germany also has a very stable economy, which is a good thing for investors. Germany has a good infrastructure, which is a good thing for real estate sector investors.

Figure 4.4 Would EMU memberships of Denmark, Sweden, Estonia, Latvia, Lithuania and Poland increase your FDI in these countries? (1= not at all, 5= very much) (results presented in percentages)



Estonia will adopt the Euro in 2011 and most of the respondents would like to see the Euro area to expand to other BSR countries, too. Exchange rate changes create an unnecessary risk, so getting rid of that would increase FDI.

Most respondents said that they think of BSR countries as separate countries. This is very understandable. Real estate investors are mostly concerned about market size and stability, so they do not put much emphasis on the countries' neighbours, i.e. transport costs etc.

4.2 Finpro register

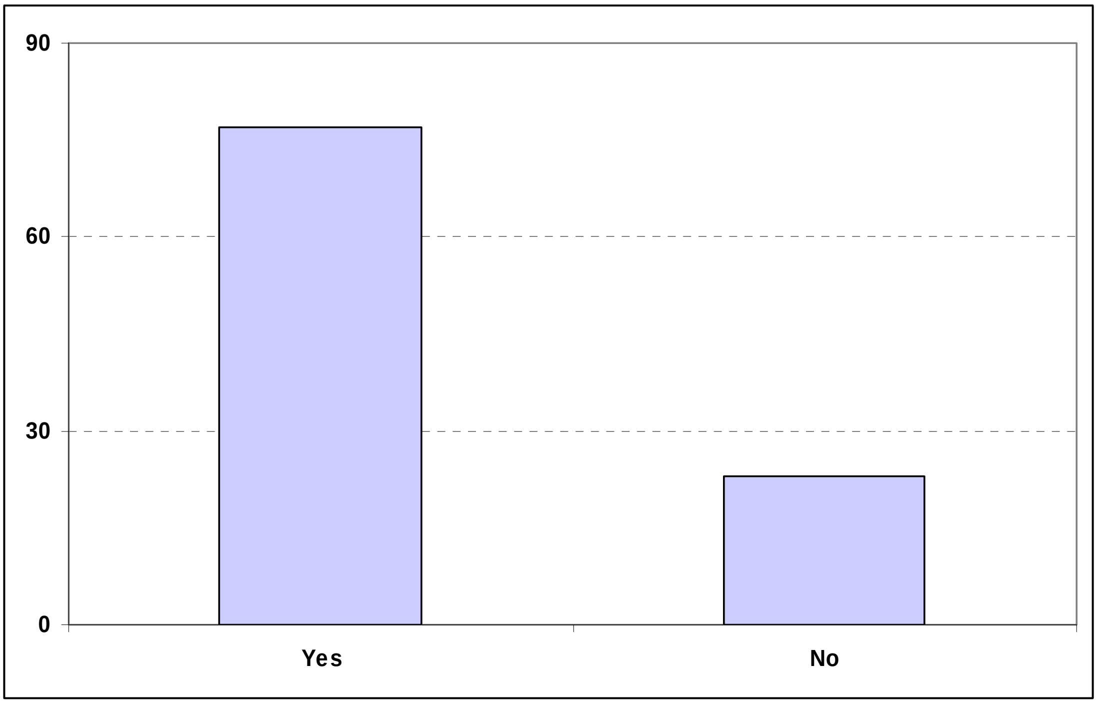
Getting contact information for international surveys is hard because most firms are very reluctant to give their e-mail addresses to outsiders. We have however been able to get a mailing list from Finpro, which is a global expert network established by Finnish companies. Its purpose is to promote the growth and competitiveness of Finnish companies through internationalization.

The problem with Finpro data is that it only has the contact information of Finnish firms. The good thing is that it has the direct addresses of those persons in different companies that are in charge of investment in different countries. We have also been able to take a subsample of those firms that are active in the BSR.

The total mailing list had 320 different e-mail addresses and we received answers from 36 companies. This means the response rate was a bit over 11 per cent, which is fairly standard for e-mail questionnaires of this type (see for example Alho, Kaitila and Kotilainen, 2004). In this type of a survey it is not wise to try to estimate statistical significance. This is because the overall percentage of answers is too low. There is probably some sort of bias in the selection for those companies that have had the time to answer our questionnaire. For example, some large companies might think that they are unable to participate because of the insider legislation that concerns companies that are listed in the stock market.

The questionnaire consisted of ten questions that were in most parts the same as in the questionnaire that was sent to companies that participate in the MIPIM real estate fair. This means that we are able to compare the results and see if there are any similarities.

Figure 4.5 Does your company have foreign direct investment (FDI) or do you intend to invest in the next 5 years in Denmark, Estonia, Germany, Latvia, Lithuania, Poland, Sweden or St Petersburg, Leningrad region and Kaliningrad? (results presented in percentages)



From our first question (Figure 4.5) we see that most companies that answered had some investment in the BSR region. Those firms that answered “No” are only exporting to the BSR so they are excluded from the questions that concern investing.

From question number two (Figure 4.6) we can see that the most popular destination for investment is St Petersburg, the Leningrad region and Kaliningrad, the most important place being St Petersburg. This is natural because St Petersburg has the biggest market potential next to Finland. If we had sent our questionnaire to a group of Spanish firms, the results might have been different.

Figure 4.6 Please indicate in which countries you have made and are planning to make investments (results presented in percentages)

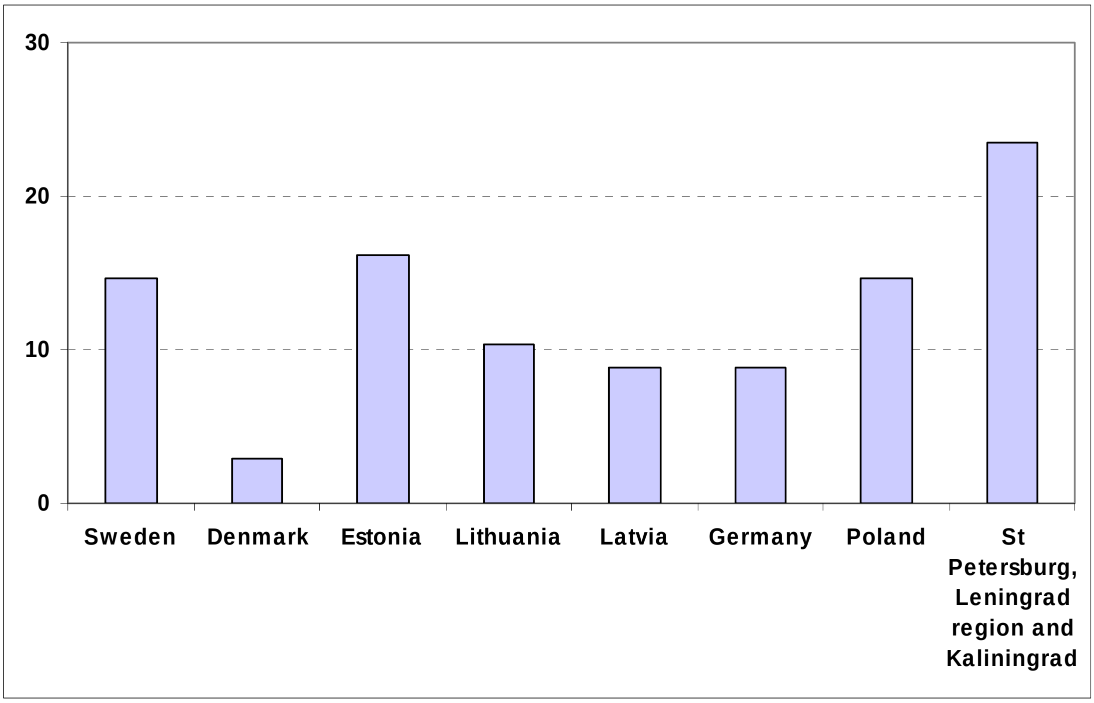


Table 4.2 What kind of foreign direct investment (FDI) do you have in each country? (results presented in percentages)

	Production of the final product	Production of components	Support activities (bookkeeping, telephone etc. services)	Research and development	Marketing	Jointly owned company in any of the mentioned fields	All
Sweden	3.5	0.7	1.4	0.7	6.9	1.4	14.6
Denmark	1.4	0.7		0.7	1.4		4.2
Estonia	4.9	0.7	0.7	1.4	5.6	3.5	16.7
Lithuania	2.8		0.7	0.7	3.5	2.8	10.4
Latvia	1.4			0.7	2.1	1.4	5.6
Germany	2.8	0.7		1.4	2.1	0.7	7.6
Poland	3.5	1.4	0.7	0.7	2.8	4.9	13.9
St Petersburg, Leningrad region and Kaliningrad	7.6	2.1	2.1	1.4	9.0	4.9	27.1
All	27.8	6.3	5.6	7.6	33.3	19.4	

The second most popular destination for investment is Estonia, which does not have a big market potential but is located less than 100 kilometres from Helsinki. Sweden and Poland are approximately equally popular places for investment. Finnish companies have had close ties to Sweden for centuries, but the rise of Poland as a place for investment is something new. This might be because of the strong economic growth that has happened in Poland in recent years. Poland is also a big country, so it has a big market potential. It is not as close to Finland as Latvia and Lithuania, but the price of sea freight is low.

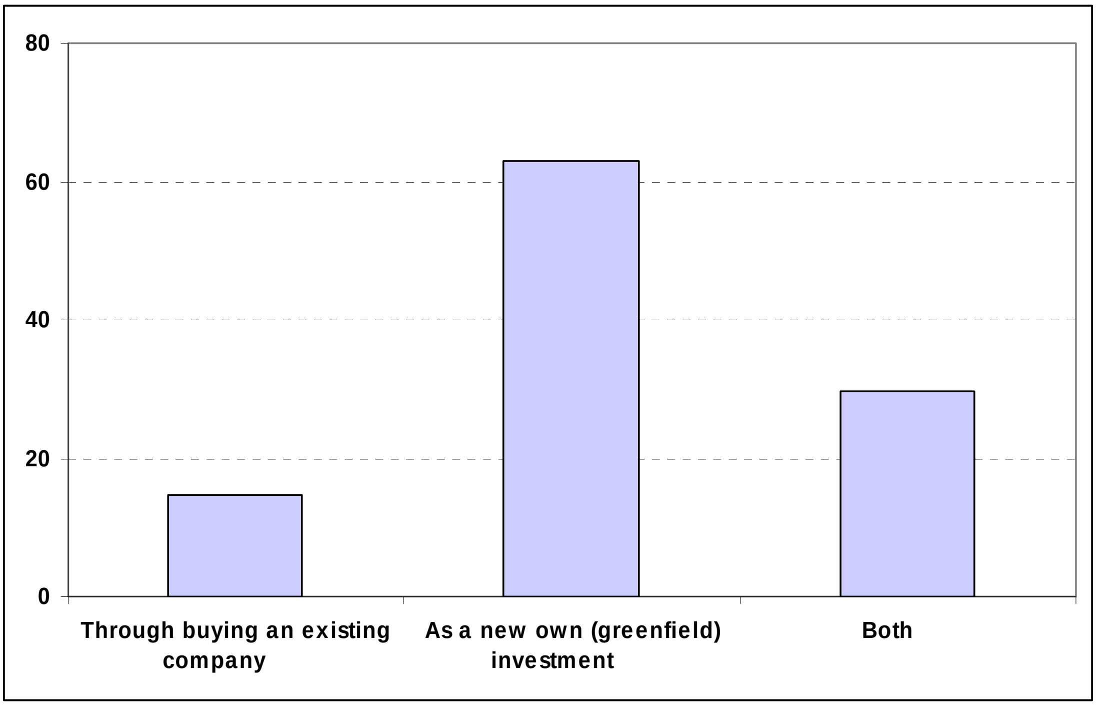
Table 4.2 shows the type of foreign direct investment that Finnish companies have in the BSR. The two biggest types of investment are production of the final product and marketing. Most of the production is done in St Petersburg. This is natural because St Petersburg is a port to the whole Russian market, and because labour costs are a lot lower there than in Finland. Many Finnish firms also have production in Estonia. In addition to the near geographic and cultural location, this is probably also because of low labour costs.

The fact that so many companies have made investment in order to market their products in different BSR countries shows that this type of activity is best to do close to the final consumer. A foreign marketing agency does not necessarily understand the specific cultural factors of another country. This means that it is wise for a company to invest in a specific country in order have good results.

Almost seven per cent of those companies that answered have made investments for marketing in Sweden. This might be because the Swedish market can be very lucrative, but also hard to conquer. It is common that in rich countries competition is tougher than in poorer countries. This means that companies must invest more in marketing.

Many companies have R&D activities also in “new” EU countries. This means that companies are not only interested in lower labour costs. R&D jobs are usually highly paid. Foreign R&D investment is also hard to do unless there is enough educated labour force in the destination country.

Figure 4.7 Is the investment made…? (results presented in percentages)



Most investment in the BSR is made as a new investment. This is probably because the majority of Finnish investment in the BSR is made in fast growing markets. Russian and Estonian markets are growing at a fast pace and their economy lacks the sort of companies that Finnish firms are establishing. For example, companies that invest in Sweden are more likely to buy an existing company.

This shows how important foreign direct investment is for countries' economic growth. Poorer countries often lack the necessary capital or know-how to establish new firms. Foreign investment also transfers technological knowledge to the receiving countries so its presence helps countries in the long term, too.

Table 4.3 Has any investment promotion agency of the corresponding country influenced your investment decision? (1= no effect, 5= strong positive effect) (results presented in percentages)

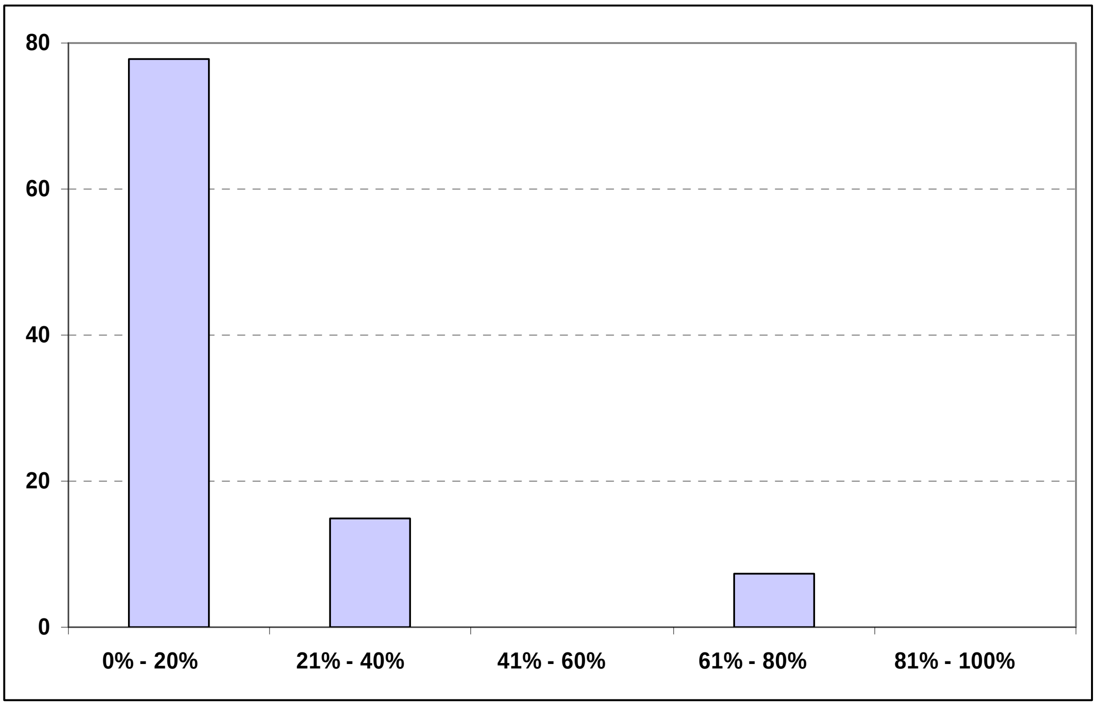
	1= no effect	2	3	4	5= strong positive effec
Sweden	17.9				
Denmark					
Estonia	7.1	3.6			
Lithuania	3.6			3.6	
Latvia	3.6		3.6		
Germany	3.6				
Poland	7.1	3.6		3.6	
St Petersburg, Leningrad region and Kaliningrad	35.7		3.6		
All	78.6	7.1	7.1	7.1	

Table 4.3 shows that investment promotion agencies do not affect companies' decision making very much. A majority of those firms that answered thought that they have no effect. This is a fairly expected answer. Different companies have different needs and they have the best knowledge of their own situation and the way they are making their investment. There are however differences between countries. In Lithuania, Poland and Latvia the agencies have a stronger influence than, for example, in Sweden and Germany.

Government-run agencies can provide some information but most companies that invest abroad have done their own calculations long before they enter a new market. For example, if a company is interested in low labour costs and access to a larger market, then it makes an investment if these conditions are fulfilled. This sort of data is rather easy to get so a promotion agency is often unnecessary. Some firms can also be reluctant to trust government-funded organizations.

The best way for a country to lure foreign direct investment is to provide a good and stable infrastructure and low taxes. A friendly environment for companies means profits and success stories and that combination is a bigger attraction than any government-produced advertisement. Investment promotion agencies can, however, have a role in making countries and their general investment conditions known, although their role in the actual investment decision is small.

Figure 4.8 How much turnover did you receive from Denmark, Estonia, Germany, Latvia, Lithuania, Poland, Sweden or St Petersburg, Leningrad region and Kaliningrad as a share of your total turnover (2008 or latest year available)? (results presented in percentages)



Economic importance of the BSR is relatively small for most of the companies that answered the questionnaire (Figure 4.8). Almost 80 per cent of the companies received less than 20 per cent of their annual turnover from foreign BSR countries. This is not surprising because most companies that are active in the BSR, operate also in Finland and in non-BSR countries.

A strange part in Figure 4.8 is that some of the companies receive over 60 percentage of their annual turnover from the BSR (excluding Finland). This is explained by companies that have large investment in Russia. It represents such a big market that some companies specialize in doing business there. These sorts of companies are not interested in the BSR as a relevant concept for their businesses.

Table 4.4 shows the biggest motivations for companies' investment in different BSR areas. We see that the most important factors for investments are factors related to size, growth and the location of the market. Altogether they represent over 50 per cent of the answers. Other important motives are favourable labour costs and proximity of the Russian market. This shows how market potential is the leading force behind foreign direct investment.

We see that especially for Russian regions the factors related to market size, its growth and location, dominate. For the Baltic countries growth potential, location factors as well as low costs are important. In the case of Germany and Poland the size of the market is important. Grouping these countries together gives, however, misleading information on the importance of labour costs. They are important in Poland but not in Germany, although the price competitiveness of the German economy has improved lately. In the case of the Nordic countries location, size of the market, good infrastructure and the stability of the economies dominate.

Table 4.4 Please indicate in which of the countries the following motivations were/are SIGNIFICANT factors in making investment (results presented in percentages)

	Nordic countries	Baltic countries	Germany and Poland	St Petersburg, Leningrad region and Kaliningrad	All
Size of the market	2.4	0.5	5.7	6.6	15.1
Growth potential of the market	1.4	2.8	3.3	8.0	15.6
Strategic location with respect to marketing	3.3	3.3	4.2	6.1	17.0
Strategic location with respect to materials and/or production	0.9		0.9	1.9	3.8
Easy access (air, sea and land)	1.4	2.4	1.9	2.8	8.5
Beneficial labour costs		3.3	3.3	2.4	9.0
Beneficial taxation		2.4			2.4
Educated labour force	1.9	0.9	1.9		4.7
High R&D level and its availability in the host country	0.9		0.5		1.4
Availability of support services	0.9		1.9		2.8
Good infrastructure	2.4	0.9	2.4		5.7
Good living conditions and related services	0.9		0.5		1.4
Stability of the economy	2.4	0.5	1.9		4.7
Proximity of the Russian market		1.9		6.1	8.0
All	18.9	18.9	28.3	34.0	

The results in Table 4.5 are a bit mixed. Finnish companies do not think that EMU membership would affect their investment in the Baltic countries much. On the other hand, some answers show that the EMU membership of Sweden and Poland would be an improvement. This is probably because exchange rates in the Baltic countries are fixed. In Sweden and Poland companies have to protect themselves against changes in the Euro exchange rate and this can be costly. On average most companies would like to see more countries adopting the Euro but it is not a high priority question. The common currency would eliminate transaction costs and exchange rate uncertainty between the Baltic Sea countries. This would stabilize competitiveness between different locations as well as reduce costs in foreign trade and FDI. It would, however, also entail disadvantages by eliminating the diversification benefit that arises from having businesses in several currency areas inside the BSR.

Table 4.5 Would EMU memberships of Denmark, Sweden, Estonia, Latvia, Lithuania and Poland increase your FDI in these countries? (1= not at all, 5= very much) (Results represented as percent)

	1= not at all	2	3	4	5= very much
Denmark	9.3	2.3	2.3		
Sweden	7.0	4.7		2.3	2.3
Estonia	7.0	4.7	9.3		
Latvia	2.3	4.7	2.3		
Lithuania		4.7	2.3	9.3	
Poland	11.6		7.0		4.7
All	37.2	20.9	23.3	11.6	7.0

Table 4.6 Does the Baltic Sea Region, as defined, form a relevant business area or concept for your firm or do you treat each country separately? (In case the company is the parent company of a group, please answer at the level of the whole group.) (Results are presented in percentages)

1= Countries separately	2	3	4	5= BSR is a very relevant business area
88,9	11.1			

We can see from Table 4.6 that a big majority of the companies that answered did not see the BSR as a relevant concept in their FDI activity. Somewhat more than 10 per cent saw some meaning in it. This might be because Finnish companies are a part of the BSR themselves. An executive in an American company could have seen this question differently. It is also possible that the BSR should be regarded as a meta concept describing the whole area, but that its importance in the actual decision making of most firms is small. There are certainly some firms for which the BSR is logistically important. Because the number of them can be rather small, it is possible that they were not represented among the respondents (=did not answer).

We also asked the companies to relate the most important obstacles to FDI in the BSR and also the attractions of the BSR. The most commonly reported attraction was market potential. On the other hand, companies seemed to answer mostly about those countries where they had some business. This means, for example, that companies that have investments in Russia were mostly concerned about legal issues and bureaucracy. Companies that worked in the Nordic countries thought that the cultural similarity made things easier for investment.

4.3 Common results of the two enquiries

Both datasets gave similar answers to some of the questions. In most firms FDI to the BSR was made with respect to the production of the final product. This was especially true in those cases where companies' investments were made in lower-income countries such as Poland and the Baltic countries. In these cases one of the main reasons for investment was low labour costs.

As an average the respondents did not see much use for different investment agencies in their actual investment decision. Answers varied, however, across different BSR countries. In rich countries such as the Nordic countries the effect of investment promotion agencies was low but in some lower-income countries, especially in Estonia and Poland, the effect was larger. This sort of questioning is somewhat hard to do because it is possible that respondents do not fully know the real effect of such agencies. It is likely that investment promotion agencies do a lot of work that is hidden from corporate executives. Their activity is also rather general so that the firms do not always "remember" their role at the initial phase of an investment project.

In both enquiries the respondents said that approximately 20 per cent or less of their total turnover comes from foreign BSR countries. This is quite expected because firms that have branches in different countries usually spread their business over large areas. On the other hand, this shows that the BSR is just a part of the companies' business environment. There were only a few companies that were mostly doing their business in the BSR countries.

Respondents to both enquiries answered that the biggest motive for foreign direct investment in the BSR countries was the size of the market. This is consistent with most of the economic studies done about FDI. In the Baltic countries and in St Petersburg area the growth potential of the market was an important factor for investment. In the Nordic countries and in Germany economic stability and other social indicators motivated some of the investment. In these countries one important motive was also the educational level of the labour force and high R&D level.

Most respondents thought the BSR as a group of individual countries. This is very understandable because it is well known that the BSR is a very heterogenic group. Different legislation and currencies make it hard to see the BSR as some sort of single market. This does not, however, mean that for some types of firms logistical and other geography-related factors are unimportant.

5 Summary and conclusions

We have defined the Baltic Sea Region as consisting of the following countries and regions: Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden, and the regions of St Petersburg, Leningrad Oblast and Kaliningrad in Russia. We have investigated factors affecting FDI in the Baltic Sea Region in three ways. First, we have studied the factors affecting FDI in general. Secondly, we have studied the characteristics of FDI in the Baltic Sea Region. Thirdly, we have researched the investment motives through two firm questionnaires: firms participating in the MIPIM real estate fairs and Finnish firms active in the Baltic Sea Region (Finpro register). Our aim was to send the questionnaire also to firms participating in the Hannover Messe, but we did not succeed in getting the e-mail addresses of the persons making FDI decisions in those firms.

At a general level attraction factors for FDI can be classified according to the level at which they work. We have classified them as follows: 1) the general policy framework, 2) policies specific to FDI, and 3) economic determinants by type of investment.

The general policy framework includes economic, political and social stability, good governance (transparent and credible policies and their enforcement), policies on functioning and structure of markets, especially competition and mergers & acquisition (M&A) policies, private property protection (including intellectual property rights, IPRs), industrial and regional policies, development of competitive clusters, trade policy (tariffs and non-tariff barriers) and stable exchange rates. These factors are not determined solely to attract FDI. They affect FDI independently from sectors. Their importance can, however, vary between sectors.

Policies specific to FDI include bilateral international investment agreements (IIAs), investment incentives and performance requirements (pre- and post-entry), pre- and post-investment services (e.g. one-stop shopping), and social amenities (international schools, quality of life etc.)

Economic determinants for FDI can be divided by type of investment as follows: 1) market-seeking investment, 2) resource-seeking investment, 3) efficiency-seeking investment, and 4) asset-seeking/asset-augmenting investment.

Market-seeking investment includes market size and per capita income, market growth, country-specific consumer preferences, structure of markets, psychic distance, and access to regional and global markets. Resource-seeking investment includes land and building costs: rents and rates, cost of raw materials, low-cost unskilled labour, and availability and cost of skilled labour. Efficiency-seeking investment includes costs of resources and capabilities listed under (b) adjusted for productivity of labour inputs, other input costs, e.g. transport and communication costs to, from and within the host economy, membership of a regional agreement conducive to promoting a more cost-effective inter-country division of labour, and quality of market-facilitating institutions. Asset-seeking/asset-augmenting investment includes competition policy (including M&As), technological, managerial, relational and other created assets, physical infrastructure (ports, roads, power, telecommunications), and macro-innovatory, entrepreneurial and educational capacity/environment.

In relation to GDP the Baltic countries have received the most net FDI in the BSR during 2000-2008. Among them Estonia has been the greatest beneficiary. This reflects the shortage of domestic capital as well as several attraction factors in the country. Estonia has attracted FDI in manufacturing and banking sectors. Among the "old" EU countries Sweden has received net FDI the most. One reason for this is international mergers and acquisitions of big companies, the resulting firms of which have been registered in Sweden (like Nordea Bank). In Denmark and Germany the majority of FDI has gone to the real estate and business activities sector. In Finland and Poland manufacturing has been the most important sector for FDI.

About a quarter of EU's business enterprises are registered in the Baltic Sea Region countries. This is mostly due to the large size of the German economy. In reality clearly fewer firms are actually registered near the Baltic Sea.

The World Bank's "ease of doing business" index indicates that Denmark is the most attractive place for FDI. Finland is the second easiest country to do business. The Russian Federation is the least attractive country to do business. The second less attractive country is Poland.

With respect to the "employment rigidity" index the differences are smaller. Denmark is also according to this measure the most attractive country. Contrary to the "ease of doing business" index, Poland has the second lowest employment rigidity in the economy. Estonia is the least attractive.

In the empirical questionnaire-based study we could not ask the firms about all possible factors that might affect their FDI decisions. We had, instead, to concentrate on a manageable number of questions. An additional limiting factor was that the firms had to answer each question for all countries where they have FDI or where they intend to invest. We presented them ten questions, which aimed at getting information on 1) the level, importance and type of investment in the BSR, 2) the motives of FDI divided into 15 classes of motives (reflecting the motives presented theoretically above), 3) the importance of EMU membership of the non-Euro area countries, and 4) the relevance of the BSR as a geographic area in their investment strategy. We also presented an open question on the most important attractions and obstacles for FDI in the different BSR countries. The common features in both enquiries were:

- The most important reasons for FDI are market size and its growth potential.
- Companies do not see the BSR as a single market in their actual decision making process.
- There are clear benefits in having the non-Euro area countries join the Euro, but the results are not very robust. Obviously the net benefits of the Euro are diminished by the already rather credible pegs of the Estonian, Danish, Latvian and Lithuanian currencies and the diversification benefits of the floating Swedish krone. Real estate firms seem to stress the benefits of the Euro somewhat more than the Finpro firms.
- Governmental investment promotion organizations have a fairly small role in the actual investment decision making process. Their role is rather in giving general information on the country's investment environment.

There are also some differences between the real estate firms and the Finnish firms active in the BSR. They include:

- In the real estate sector the majority of FDI is made by buying an existing firm, whereas in the sample of Finnish firms most FDI is made as a greenfield investment (establishing a new firm).

- Among the real estate firms Sweden, Finland, Germany and Poland are the most important destinations for FDI. In the Finnish sample of firms (including more manufacturing and service firms) St Petersburg, Poland, Estonia and Sweden are the most important destinations.
- In the sample of real estate firms R&D and proximity of the Russian market are not important motives for FDI, contrary to the Finnish, more manufacturing and retail trade-oriented sample – for understandable reasons.
- Among the real estate firms the potential for large increases in real estate prices is an important motive for FDI.

Possible future scenario: Baltic countries converge towards the Nordic countries. They are small and very dependent on foreign trade and they are probably the biggest beneficiaries of the deepening economic cooperation in the BSR. They need FDI more than the other BSR countries. Like Germany also Poland has a big domestic market and it can prosper even without the other BSR countries. Russia has its own problems and although it has a huge market potential it suffers from arbitrary legislation and bureaucracy. In the future there are potentially three different blocs in the BSR: Nordic and Baltic countries, central European BSR countries (Germany and Poland) and Russia.

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ANNEX

1 Internet questionnaire

A link to the internet questionnaire was sent three different times to MIPIM and Finpro respondents. The enquiry was first sent in June and then again in July and August.

The size of the MIPIM sample was over 1000 e-mail addresses. The exact amount is hard to say because there were a lot of errors in the e-mail addresses so not all e-mails went through. The number of respondents for MIPIM was 19 so the overall response rate was low.

The Finpro register included 320 e-mail addresses and the amount of respondents was 36. This is somewhat standard response rate for this sort of enquiry.

Covering letter:

Baltic Metropoles
BaltMet Promo

The Research Institute of the Finnish Economy
(ETLA) June 29th, 2010

Questionnaire on the Motives for Foreign Direct Investment in the Baltic Sea Region

The BaltMet Promo project, funded by the Baltic Sea Region programme of the European Union, promotes the Baltic Sea Region (BSR) on a global scale for tourists, talents and investors (http://www.baltmetpromo.net/public/).

A part of the project concerns the motives/reasons for foreign direct investment (FDI) in the Baltic Sea Region. This part of the project is conducted by the Research Institute of the Finnish Economy (ETLA).

We kindly ask you to answer the following questions, which takes only about 10 minutes, before July 15th, 2010.

All individual answers will be confidential and only average data will be published.
If you have any problems in answering, do not hesitate to contact Research Fellow, Mr. Nuutti Nikula, who is responsible for the survey (nuutti.nikula@etla.fi and tel. +358 9 609 90 247).

Thanking for your contribution,

Markku Kotilainen
Research Director
The Research Institute of the Finnish Economy (ETLA)
markku.kotilainen@etla.fi

Baltic Sea Region
Programme 2007-2013
Part-financed by the European Union

Questions

1. Does your company have foreign direct investment (FDI) or do you intend to invest in the next 5 years in Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Poland, Sweden or St Petersburg, Leningrad region and Kaliningrad?

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2. Please indicate to which countries you have made and are planning to make an investment.

Denmark
Estonia
Finland
Germany
Latvia
Lithuania
Poland
Sweden
St Petersburg, Leningrad region and Kaliningrad

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3. What kind of foreign direct investment (FDI) do you have in each country?

Number of question respondents

Production of the final product
Production of components
Support activities (bookkeeping for accounts receivable and payable, telephone etc. services)
Research and development
Marketing
Jointly owned company in any of the mentioned fields

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4. Are the investments made…?

Number of question respondents:

By buying an existing company
As a new own (greenfield) investment
Both

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5. Has any investment promotion agency of the corresponding country influenced your investment decision? (1= no effect, 5= strong positive effect)

Denmark
Estonia
Finland
Germany
Latvia
Lithuania
Poland
Sweden
St Petersburg, Leningrad region and Kaliningrad

6. How much turnover did you receive from each of the countries as a share of your total turnover (2008 or latest year available)?

0% - 20%
21% - 40%
41% - 60%
61% - 80%
81% - 100%

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7. Please indicate in which of the countries the following motivations were/are SIGNIFICANT factors in making investments.

Nordic countries
Baltic countries
Other (Germany and Poland)
St Petersburg, Leningrad region and Kaliningrad

Size of the market
Growth potential of the market
Strategic location with respect to marketing
Strategic location with respect to materials and/or production
Easy access (air, sea and land)
Beneficial labour costs
Beneficial taxation
Educated labour force
High R&D level and its availability in the host country
Availability of support services
Good infrastructure
Good living conditions and related services
Stability of the economy
Proximity of the Russian market
High increase potential of the real estate prices

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8. Would EMU memberships of Denmark, Sweden, Estonia, Latvia, Lithuania and Poland increase your FDI in these countries? (1= not at all, 5= very much)

Denmark
Estonia
Latvia
Lithuania
Poland

---

9. Does the Baltic Sea Region, as defined, form a relevant business area or concept for your firm or do you treat each country separately? (In case the company is the parent company of a group, please answer at the level of the whole group.)

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10. Mention the most important attraction and obstacle for FDI in relevant BSR countries.