Future Prospects For Foreign Investment In Lithuania: Does This Baltic Tiger Still Have Teeth?

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ABSTRACT

Lithuania's economy has gone through stages of feudal system, serfdom, centrally planned command economy and market-based economy. After its liberation at the end of the last century, Lithuania's transition is in process, as evidenced by the development of economic frameworks. Radical reforms, including the opening of markets, implementation of flat tax rates, rapid privatization of businesses, and efforts to maintain a stable currency, set the tone for phenomenal economic growth, not only in Lithuania, but in neighboring Estonia and Latvia as well. The Baltic Region experienced monumental growth in the mid to late 1990s, which accelerated through the early 21st century. Sweeping reforms and growth culminated with the accession of Lithuania into the European Union in 2004. The combined economic story of Lithuania, Estonia and Latvia is quite comparable to that of the Asian Tigers of South Korea, Hong Kong, Singapore, and Taiwan. The three countries have thus earned the title of The Baltic Tigers. Lithuania's accession into the EU fostered further development of the country and its economy on both the financial and political fronts.

Keywords: Emerging market, Financial regulation, Lithuania, FDI, FPI

ECONOMIC EMERGENCE OF LITHUANIA IN THE GLOBAL MARKET

The Republic of Lithuania has a rich history dating back to the Middle Ages. Like many countries, such a rich history has involved times of economic prosperity and hardship as well as conflict with other nations. For several centuries, the country's economy was based on the feudal system. Upon the abolition of serfdom in the early 1800's, a market-based economy slowly began to emerge in the region. The slow transition experienced several setbacks most notably due to significant conflicts such as WWI and WWII though Lithuania gained independence for a brief time between the wars. At the conclusion of the Second World War, modern day Lithuania was annexed by the Soviet Union. This effectively halted all economic transformation given the Soviet doctrine of a centrally planned, command economy.

In 1990 Lithuania declared independence from the former Soviet Union and in 1993 after several small conflicts, the Soviet Union withdrew all military forces from Lithuania. Following the transition in power, Lithuania began to develop the framework necessary to develop a market based economy. Radical reforms including the opening of markets, implementation of flat tax rates, rapid privatization of businesses and efforts to maintain a stable currency set the tone for phenomenal economic growth not only in Lithuania but in neighboring Estonia and Latvia as well. The Baltic Region experienced monumental growth in the mid to late 1990's which accelerated through the early 21st century. Sweeping reforms and growth culminated with the accession of Lithuania into the European Union in 2004. The economic story of Lithuania and neighboring Estonia and Latvia is quite comparable to the Asian Tigers of South Korea, Hong Kong, Singapore, and Taiwan. As a result, the three countries are often referred to as "The Baltic Tigers". Lithuania's accession into the EU fostered further development of the country and its economy on both the financial and political fronts. The requirements for EU membership are substantial and multi-faceted and cannot be overemphasized. For Lithuanian, membership in the EU signifies the country's openness and cooperation on multiple fronts including governmental, regulatory and economic affairs. Even with EU membership, Lithuania is still an emerging market in transition. To evaluate the opportunities for investment in the country properly, it is necessary to have an understanding of several factors that have pave the way for success and will affect the future prospects for development within the Republic of Lithuania and its economic system.

LITERATURE REVIEW

The impact of foreign direct investment (FDI) on growth of economy in Lithuania has been studied by numerous scholars (Tvaronavičienė and Grybaitė, 2007). The economies of Estonia, Latvia and Lithuania have experienced unprecedented economic growth thanks to the boom of FDI (Fifka, 2008). The Baltic States are considered attractive for FDI as they demonstrate high growth and represent new unsaturated market (Tvaronavičienė, Grybaitė, and Korsakienė, 2008). The study of integration to the European economic sphere through FDI and international trade has not prevented job losses in the manufacturing industry in the Central and East European countries of Czech Republic, Hungary, Poland, Slovakia, Slovenia, Lithuania, Bulgaria, and Romania (Onaran, 2008). Studies have been devoted to reveal differences in innovative behavior of business firms, characterized by scale of investment in research and development, self-financing pattern and business strategy, containing foreign and not foreign capital (Tvaronavičienė and Manuela; 2007). The creation of Free Economic Zones (FEZ) in 1995 was to effectively attract and make conditions favorable for Foreign Direct Investments, creation and transfer of knowledge and new technologies, and also new job creation (Auruskeviciene, Salciuviene, Kuvykaite, and Zilys, 2007). Another study comparing and contrasting early movers and late entrants finds general support for early mover advantages in Hungary and Poland but not so in Lithuania, suggesting that early entry is a trade-off between risk and return (Jakobsen, 1997). The role of Norwegian MNEs and their FDI in emerging economies especially in Lithuania is interesting because Lithuania is an example of a new emerging economy and Norway is an example of a newcomer as a foreign investor (Amdam, Petter and Randi; 2007). Transformations of banking sector in terms of number and capital origin of market players, sector expansion, concentration and financial performance efficiency have been feasible only thanks to an influx of FDI during 1996 to 2005 (Aleknavičienė and Tvaronavičienė, 2006).

FINANCIAL SYSTEMS AND REGULATORY ENVIRONMENT IN LITHUANIA

Banking System

The banking system in an economy is a cornerstone for development and stability regardless of the level of economic development. Similar to the Lithuanian economy, the banking system has experienced rapid change. As is often the case, the emerging market in Lithuania offered opportunities for developed foreign commercial banks to expand their reach while bringing significant experience to a new market. State owned and controlled banks began to privatize in the mid 1990's offering access to the market. In 1999, foreign banks took 50% ownership stakes in five commercial banks bring with them experience and services not previously available in the Lithuanian market. The ability of foreign banks to operate in the market more efficiently and offer credit more easily than domestic banks led to further consolidation in the existing banking industry and entry of additional foreign banks. From 1996 through 2006, the number of banks rose from twelve to thirteen. Of these banks, nine were originally domestic banks but by 2002, that number had fallen to only two. (Aleknavičienė & Tvaronavičienė, 2006). This transition in the banking sector of the county is complete for the most part with generally positive results as credit has been freely available and the foreign entities in the banking industry have experienced significant capital and profitability increases since entering the market. One area of potential concern stems from a high concentration of total loans being held by only three banks. Such a concentration increases the level of system risk particularly in the current global economic environment (Rutkauskas & Dudzeviciue, 2005) .

Regulation of the Lithuanian banking industry is the responsibility of the Bank of Lithuania; the country's central bank. The Bank of Lithuania operates independent of the Lithuania government similar to the United States Federal Reserve and the Bank either is a party to or follows all major international banking agreements. Duties of the Bank of Lithuania include overall industry regulation, setting monetary policy and determining the exchange rate for Lithuania's currency, the litas, which is pegged to the Euro. The setting of exchange rates is a function that is projected to end as Lithuania is currently working to convert to the Euro in the near future. The Bank of Lithuania is a member of the European System of Central Banks (ESCB).

Capital Market System

The capital markets in Lithuania are much less developed than the banking system however, they are becoming more developed as listings have been on the increase in the past decade. The Vilnius Stock Exchange (VSE), formerly the Lithuania Stock Exchange, is part of the NASDAQ OMX. Privatization of the National Stock Exchange of Lithuania took place via strategic partnerships offering investors access to other European markets. As one would expect the larger markets continue to overshadow the emerging market exchanges often drawing away foreign capital (Levišauskaitė & & Koncevičenė, 2004). This situation should improve over time as strategic alliances with other markets are evaluated and implemented and demand for capital from Lithuanian companies grows.

The VSE maintains three trading lists, the Official List, the Current List and the Unlisted Securities. The number of companies listed on each list varies but in general, the Official List and the Current List generally contain less than fifty Lithuanian corporations. Unlisted Securities are much more numerous and generally include over 1,000 issues. The VSE is the only secondary market in the country. Though the number of listed companies may seem small compared to many trading markets, there has been a significant increase in listed companies in a few short years. The bond market, which until recently traded only governmental bonds has even fewer instruments listed now. In addition to equities and bonds, investors in the Lithuania markets have access to a variety of investment known as collective investment undertakings or CIUs (similar to mutual funds in the United States) as well as hedge funds and other investment vehicles. CIUs have seen rapid growth in recent years as a result of the country's economic situation. Lithuanian citizens have benefited from the growing economy and are seeking investment opportunities as a result. This in turn has created demand for transformation in the financial markets as well as increased demand for new investment products offering better diversification and returns than traditional savings opportunities (Kucko, 2007). All entities offering investments, brokerage and similar financial services in the country must be registered with and licensed through the Securities Commission of the Republic of Lithuania. The Commission is the country's main regulatory body for all investment activities and offerings.

Regulation of the securities market is similar to though perhaps not as developed as that found in more developed markets. Much of this regulation has been established in an effort to make the financial markets both a safe place and attractive place to invest as well as to facilitate integration with the larger European financial markets. One area for improvement appears to be the disclosure of financial data to the public. In a study from 2000-2005, 32 of the 39 companies listed on the VSE were evaluated in terms of financial data disclosure. The findings of the study indicate that corporations with a high concentration of ownership among a limited number of individuals are significantly less likely to proactively disclose financial data. Most data disclosed are based on projections and full financial data is not easily accessible or translated into other languages (Legenzova, 2008).

Regulatory Environment

As previously mentioned each aspect of the financial market in Lithuania has a regulatory oversight. The primary regulators are the Bank of Lithuania for commercial banking and the Securities Commission for brokers and other financial intermediaries. The insurance industry is supervised by the Insurance Supervisory Authority. As financial institutions expand their services, the regulatory agencies have been proactive in providing consolidated oversight. The various agencies assisted in the drafting and passage of the Law on Financial Institutions. This law in basic terms states the regulator of the parent institution has primary oversight responsibility for the parent and any subsidiaries. Such an approach provides a clear direction for oversight but also obligates the institution to follow the requirements of the regulators who would provide oversight to any subsidiary's business (Zutautas, 2005). For example, the Bank of Lithuania regulates commercial banks but commercial banks providing brokerage services must also follow the rules and regulations of Securities Commission. Such a framework is beneficial in that the regulators are in many ways forced to work together without becoming a barrier to the institutions. In addition, transparency of the institutions is enhanced.

As emerging market economies continue to expand the need for standards in business practices becomes more apparent. To that end and related to the regulation of the banking and capital markets, establishing accounting standards becomes increasingly important. As part of the transformation from a command economy to a market economy, Lithuania has implemented accounting reforms in line with International Accounting Standards (IAS) (Gimzaukus & Valanciene, 2006). The standards provide for uniformity and transparency in financial reporting in turn making the Lithuanian market more attractive and the financial condition of Lithuania business easier to evaluate.

Tax Considerations

One cannot discuss the subject of accounting and governmental regulation without mentioning taxes. The tax situation in Lithuania offers attractive incentives and provides for economic growth. The tax system for individuals is a flat tax currently at 27% and is scheduled to be reduced to 24%. Businesses are also taxed at a flat rate but the system is somewhat more complex in that it includes VAT premiums and tax breaks for certain industries. In general, businesses are taxed on profits at a rate of 15% (Kindsfaterienė & Lukaševičius, 2008). This tax rate, which was implemented earlier this decade, further stimulates growth in the Lithuania economy and provides a favorable environment for business development. Lithuania also provides special incentives for large foreign capital investments including tax incentives based on the size of the foreign investment. Additional incentives may be also be available through local municipal governments based on the nature of the projects and the impact to the local economy.

Additional Considerations

In evaluating any emerging market, the issue of corruption must be considered. Lithuania like many emerging markets is not exempt from governmental corruption on the national, regional and local levels. Most corruption issues are related to bribes of governmental workers. It is important to note that the issue is being addressed and allegations of corruption are becoming increasingly publicized and investigated. Progress is being made with respect to anti-corruption efforts however, stronger laws to address the issue often become stalled in the legislature. The lasts Freedom House Nations in Transit Report gives Lithuania a Corruption Index of 3.75 on a scale of 1-7 with 1 being the highest score and 7 being the lowest. (Piasecka, 2008) The average corruption index for new EU members, which includes Lithuania, is 3.15 while the same score for non-Baltic former Soviet states is 6.10. Lithuania ranks 51st out of 179 countries in Transparency International's Corruption Perceptions Index for 2007. In comparing Lithuanian to other countries in the region on the matter of corruption, opportunities for improvement clearly exist. As stated previously, corruption in emerging markets is often an issue. When comparing the level of corruption to similar countries, Lithuania to other emerging markets, the country is respectable. While any level of corruption is unacceptable the majority of corruption appears to be domestic in nature with foreign firms reporting that government officials are generally honest and helpful.

CLIMATE FOR INVESTMENT IN LITHUANIAN MARKET

Portfolio Investment

One must contemplate portfolio investment and the relative safety it offers compared to Foreign Direct Investment (FDI) when considering entry into the Lithuania market. For specialized situations, the capital markets offer options for sharing in the growth of the Lithuanian economy. Though the capital markets are well developed in relative terms, the limited number of Lithuanian corporations listed on the VSE, may not offer a suitable variety of equity or bond investment options. Investors can expand their options through unlisted securities however this may not be an attractive options for most foreign investors. Given that the VSE is part of the OMX group of exchanges, a wider variety of investment options are available through the exchange however, portfolio investment for purposes of this paper are limited to Lithuanian based options only. As the capital markets continue to expand through additional Lithuania corporations becoming listened, portfolio investment may become more enticing. The country offers an attractive climate for portfolio investment by providing favorable tax treatment of investment earnings to both foreign and domestic investors. In addition, Lithuanian law treats foreign investors as equals to domestic investors with the limited exception of investment in industries related to defense and national security. No restrictions are imposed on foreign capital flow into or out of the country.

Foreign Direct Investment (FDI)

FDI in the entire Baltic region from the late 1990's to the present has been immense with a variety of both developed and developing nations investing in the country. The extensive economic growth of Lithuania and the Baltic Region as a whole has outpaced FDI in other emerging markets such as India by as much as six times during the current decade (Tvaronaviciene, Grybaite, & Korsakiene, 2008). Lithuania's entry into the EU removed other barriers to FDI. It also has provided enhanced access to the European marketplace. The explosive growth in Lithuania brings with it certain factors that may have a negative impact on continued growth. These factors included significant inflation, which currently stands at a rate of approximately five percent. Much of this is due to the very low rate of unemployment. Given that the education levels of Lithuania are quite high, skilled labor is present though not necessarily readily available. Both significant inflation and low unemployment rates tend to be signs of a rapidly growing economy.

Even when considering these factors the Lithuanian market offers much for the foreign investor. Though unemployment rates are low, wages while increasing are one-fifth of the average wage in more developed Europe (Piasecka, 2008). For companies in search of inexpensive yet educated labor Lithuania remains and attractive proposition. The low unemployment rate has also resulted in increased immigration from neighboring countries. This labor which may or may not be as highly educated will continue to keep wages in check and will likely free up some of the more highly skilled labor in the country to those companies willing to offer a slight wage premium. In addition to an attractive labor situation, Lithuanian's geographic location offers significant benefits. Situated in close proximity to many former Soviet Bloc countries and with easy access to the European market, Lithuanian offers ready access to both developing and developed markets and their participants. Historically Lithuania's primary trading partner has been Russia however, the country is increasingly pursuing trade with the West. Membership in the World Trade Organization and European Union further enhance the countries position. Table 1 shows the recent FDI inflows and stocks in Lithuania.

IMPLICATIONS OF THE CURRENT GLOBAL ECONOMIC CRISIS

The global economic crisis has affected Lithuania and the current economic situation looks much different than it did several months ago. Unemployment is rising in the country and much of the recent growth has contracted significantly or come to a standstill. Similar to other markets in the global economy, credit is becoming scarce as 85% of the Lithuanian banking system is tied to foreign owned banks. As a result, any contraction or a scaling back of lending by these banks will have a significant impact on Lithuania economic conditions. Though the Lithuania banking system is well established and well regulated reliance on the foreign banks is currently a liability to the overall economy.

Table 1 FDI Inflows and Stocks (Millions of US dollars)

	1990 to 2000 (Annual Average)	2004	2005	2006	2007
FDI Flows (Inward)					
Lithuania	271	773	1,032	1,840	1,934
Poland	3,705	13,091	10,363	19,198	17,580
European Union	209,482	214,342	498,400	562,444	804,290
FDI Stocks					
Lithuania				10,996	14,679
Poland				124,530	142,110
European Union				5,675,258	6,881,625

Source: UNCTAD, World Investment Report 2008

Still another issue looms in Lithuania's GDP figures. Both domestic and foreign demand for goods is expected to decline significantly. Real GDP growth is expected to contract from an estimated 4% in 2008 to 2 percent in 2009 (IMF, 2008). Fortunately, Lithuanian officials appear to have been at least somewhat prepared for the downturn spurred by the current crisis. In reaction to liquidity issues, the Bank of Lithuania has lowered reserve requirements from 6% to 4% and is exploring other measures to maintain liquidity in the market. At the same time, the government is tightening budgets and increasing VAT and excise taxes in an effort to reduce the deficit while reducing income taxes. These initiatives while proactive will require close monitoring so as not to negatively affect the domestic market and further slow the economy. Even with these measures, the global economic situation is changing daily and it is nearly impossible to predict the outcome the crisis will have on any specific country's economy. There is rising speculation that even for the efforts of the governing bodies of Lithuania the country may be required to pursue help from the IMF in the form of loans. This step has already been taken by some neighboring emerging market countries including Latvia.

MNCs from the US including Kraft Foods, Coca-Cola and Philip Morris, and such established European brands as Nestle, Societe Generale and Drauda are all present in Lithuania. The country has liberalized its inward FDI policy systematically and also has entered into numerous bilateral and multilateral trade agreements to promote international trade channels. Besides, Lithuania's FDI potential index stands at 40 with its performance index at 53. Table 2 shows select state-owned enterprises which may be future potential candidates for privatization and a wave of new influx of FDI.

Table 2 Selected State-Owned Enterprises in Lithuania, October 2008

S. No.	Name of the SOE	Industry	State Ownersip (%)
1	Turto Bankas	Banking	100
2	Lithuanian Radio and Television	Telecom	100
3	JSC Lithuanian Railways	Transport	100
4	Lithuanian Shipping Co	Transport	57
5	Lithuanian Power Plant (Lietuvos Elektrine AB)	Utility	96
6	Rytu Skirtomieji Tinklai (RST)	Utility	71
7	Lithuanian Gas (AB Lietuvos Dujos)	Utility	18
8	Lietuvos Energija	Utility	97
9	Ignalina Nuclear Power Plant	Utility	100
10	Klaipeda State Seaport Authority (KSSA)	Port authority	100
11	AB Mazeikiu Nafta	Oil refinery	10
12	Lithuanian Maritime Safety Administration	Maritime institution	100
13	Vilnius International Airport	Airport operation	100
14	Kaunas International Airport	Airport operation	100
15	International Siauliai Airport	Airport operation	100
16	Palanga International Airport	Airport operation	100
17	Ignalina Nuclear Power Plant (INPP)	Energy	100
18	LEO LT (Lithuanian Electricity Organization, Lietuvos elektros organizacija)	Energy	62
19	Radioactive Waste Management Agency (RATA)	Radioactive waste management	100
20	Lithuanian Mint (Lietuvos Monetij Kalykla UAB)	Mint	100
21	Lithuanian Post (Lietuvos paštas)	Postal	100

Source: WTO, Trade Policy Review, European Community, Table A III 3, Page 179

ANALYSIS AND CONCLUSION

Though the current economic situation in Lithuania can be categorized as bleak due to the global economic slowdown, more in depth analysis reveals some encouragement for the country's long-term economic viability. One can easily miss the observation that the current economic situation is in part a function of the country's rapid development and prosperity in recent years. Less developed countries around the globe are not experiencing the downturn to a similar extent simply because they have seen little or no development or growth. Look no further than the African continent for examples of this situation.

In this measure, Lithuania has proven itself as an economic powerhouse that in many ways is well on its way to become a developed economy. While the global financial situation should not be minimized or take lightly it is important to note that things will improve with time. The efforts to establish a system that encourages investment by foreign countries have clearly paid dividends to Lithuania in the form of explosive growth. Further refinement of the country's financial systems may be necessary, given the current global economical conditions. However, this should be viewed positively. The short-term pain resulting from a global slowdown provides opportunities for the Lithuanian economy to further strengthen and transform. Financial system weaknesses overlooked during times of rapid growth will now need to be addressed in context.

This in turn will make the financial and regulatory systems stronger and position the country for future growth and foreign investment. In addition, wage growth, inflation and labor scarcity will become less of an issue. These factors will enhance the attractiveness of entry into the Lithuanian market via FDI over the long term. While it is difficult to predict when the global economy will shows signs of recovery, from a theoretical perspective, Lithuania will weather the storm. The country will likely emerge as a country offering continued economic opportunity, a further refined financial system, a well educated labor force and desirable economic conditions for those looking to enter the Central and Eastern European market. Though the explosive growth rates of recent years are past, the county will likely exceed both developed countries and neighbors who are unable to navigate the current crisis without significant outside assistance. In summary, the Baltic Tiger known as Lithuania still has teeth.

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