Analysis of Economic Activity of Foreign Direct Investors in Latvia

Aleksejs Jursa

Mg. oec, University of Latvia, Aspazijas bulvāris 5, aleksej.jursa@gmail.com

Abstract. The aim of this article is to investigate the activity of foreign direct investors in Latvia and find out the main source of financing for foreign investors - new investments or reinvested earnings. To achieve the set goal, the methodology of the Sixth Edition of the International Monetary Fund's Balance of Payments and International Investment Position Manual was used to define the types of foreign direct investment (FDI). This methodology was adapted to Latvian data. At the request of the author, Lursoft IT Ltd selected business data on all registered companies with foreign capital in Latvia since 2005 and aggregate data were used in the analysis. Foreign direct investment in Latvia flows mainly in the form of reinvested earnings, due to the profit earned from operating activities in Latvia. While new investments or greenfield investments in equity is lower compared to the amount of reinvested earnings.

Keywords: *Latvia; Foreign Direct Investment; Greenfield Investment; Brownfield Investment; Investment Climate.*

Introduction

Relevance of the article

FDI is a type of foreign investment aimed at establishing a new, independent company or expand an existing business through merger or takeover. Today, these investments are an important financial instrument with a significant role in the development of economics, especially in countries where the local capital is limited. Such investments are subject to a variety of difficulties and opportunities and, therefore, FDI-related research will continue to be relevant in the future. Keeping in mind the unsuccessful approach leading up to 2008, prudent bank crediting policy prevents companies from obtaining the necessary flow of money for investments. The existing approach of the banks in issuing loans is much more careful. On the other hand, other types of financial instruments are limited; risk capital is very poorly developed in the Latvian market. The issuance of bonds is relatively expensive. Prudent commercial banking policy is not the only reason for weak local investment activity. Based on a study by Stockholm School of Economics in Riga on the shadow economy in the Baltic States, in Latvia, the shadow economy in 2019 was 23.9% of GDP, which is a high number (Stockholm School of Economics, 2020). It is also important to note that out of all companies that submitted annual reports to Lursoft IT Ltd in 2019 (109.5 thousand companies) only 66 thousand had an annual turnover up to 12 million euro. In turn, only 56.8% of these companies have positive equity and positive profits. It can be concluded that the range of potential companies to which commercial banks can issue loans is limited. Thus, faster investment development is hindered by both demand and supply factors. In light of low investment activity, it is very difficult to increase productivity. Until then, foreign direct investment can supplement local capital.

Level of problem investigation

Since the restoration of Latvia's independence, Latvia has attracted almost 16 billion euro of foreign direct investment. This corresponds to 52.3% of Latvia 's nominal GDP in 2019. There have been no studies on whether this significant FDI inflow was invested in the creation of new companies, or the so-called "greenfield" investments, or in the takeover of existing companies.

Scientific problem

Whether the current investment environment in Latvia is favourable for acquisitions of local companies by foreign investors, but not for setting up new businesses.

Object of the article – foreign direct investment inflow in Latvia.

Aim of the article **-** to evaluate the activity of foreign direct investors in Latvia, describing the economic indicators of companies for the last 15 years.

Objectives of the article:

1. To analyze the theoretical aspects of the foreign direct investments movement.
2. To develop a methodology for the identification of greenfield and brownfield FDI.

https://doi.org/10.15388/ISC.2022.5

3. To describe the dynamics of FDI and the accumulated volume in Latvia.
4. To analyze the economic activity of foreign direct investors

***Methods of the article*:** analysis of scientific literature, statistical analysis.

1. Literature review

Theoretical studies in FDI facilitate a better understanding of economic mechanism and behavior of economic agents, both at micro and macro level, encouraging cross border investments. FDI theories could be broadly classified under macroeconomic and microeconomic perspectives (Denisia, 2010; Kaushal, 2019). Macroeconomic FDI theories highlight country-specific factors and align well with trade and international economics. Microeconomic FDI theories being firm-specific relate to ownership and internationalization benefits and incline toward industrial economics and market imperfections. These theories examine FDI motivations form the investor's viewpoint and connect with firm-level or industry-level perspective in decision making (Kaushal, 2019).

FDI has been widely accepted as an important vehicle for development because of FDI's positive effects on the host state's economy (Bao, et all 2022), including technology transfer, the introduction of new managerial skills (Denisia, 2010), increasing product quality (Lin, Lin, 2010), increasing institutional quality (Hyun, 2006), improving productivity (Liu et al., 2001) and promoting capital accumulation (Yao et al., 2016). An issue that has received limited attention in literature is that the growth effects of FDI are likely to depend on the direction of FDI flows (Sirr et al., 2018). Based on the neoclassical theory, FDI flows from more advanced to less advanced economies are expected to have the highest growth effect as the advanced countries are endowed with better cutting-edge technology and operational techniques. Therefore, the larger the gap between the country-pairs in endowments and capabilities, the higher is the spillover potential through technology, human capital, and knowledge diffusion, allowing for a faster catching-up process (Schiff, & Wang, 2008).

FDI represents one of the most researched phenomena in international business (Paul, & Singh, 2017). Over the past 70 years, many researchers have tried to explain the phenomenon of FDI, while failing to crystallize a single, generally accepted theory of FDI. Most reviews of the FDI literature do typically focus on a specific subset of FDI only. For instance, (Meyer, 2004) surveyed the research on FDI spillovers in the context of emerging market economies. (Chan et al., 2006) examined the interdependencies between FDI and MNE foreign-marketentry strategies. Blonigen (2005) reviewed past research on hostcountry-specific determinants of FDI. (Casson, 2000; Buckley, & Casson, 2009) analyzed the progress of FDI research and internalization theory.

All theories of FDI can be divided into two main groups: widely used theories and recent models and frameworks. Widely accepted theories include the following frameworks: internalization theory (Buckley, & Casson, 2009), the eclectic paradigm or Dunning's OLI paradigm (Dunning, 2001), the Product life-cycle theory (Vernon, 1966). New theories have also developed in recent years, such as: linkage, leverage, learning model (Hobdari et al., 2017), springboard theory (Luo, & Tung, 2018), conservative, predictable and pacemaker model (Paul, & Sanchez-Morcillo, 2019).

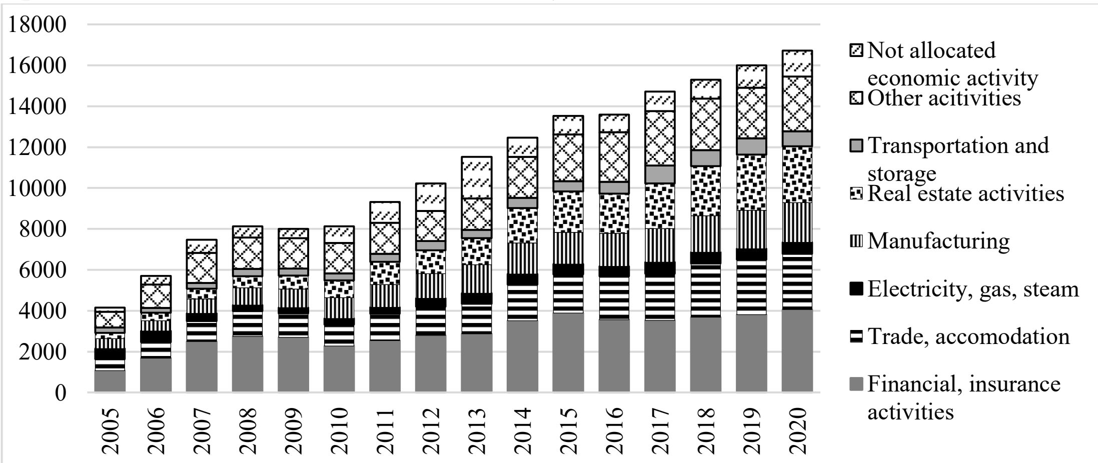
FDI can be made to start a completely new business abroad, commonly referred to as a greenfield investment, as well as in the full or partial acquisition of an existing business or in the form of a merger or takeover. FDI can be in three forms. The first form is greenfield investment. Greenfield investments imply the creation of new subsidiaries in the host economies. (Bertrand, 2004). The second form is extension of capacity. This type of FDI does not create a new economic activity, but develops already an existing one. It is an investment in previously established direct investment enterprises in the form of an increase in share capital or reinvested earnings. (Bertrand, 2004). The third form is mergers and acquisitions. (International Monetary Fund, 2009). The extension of capacity and mergers and acquisitions FDI is classified as brownfield investments.

Existing evidence strongly supports the importance of greenfield FDI to host economies, and greenfield has a significant impact on international technology spillovers. (Liu, Zou, 2008) find that foreign greenfield creates both intra-industry and inter-industry spillovers on innovation, and there exist only inter-industry spillovers from M&As. (Nocke, & Yeaple, 2007) develop an assignment theory to analyze the volume and composition of FDI. In their model, firms enter a foreign market through greenfield investment or cross-border acquisitions. In equilibrium, both types of FDI coexist within the same industry, but firms engaging in greenfield investment are systematically more efficient.

2. Dynamic of incoming oreign direct investment in Latvia

FDI plays a significant role in the growth of Latvia's economy, but there is a noticeable degree of cyclicality in the intensity of the flows. Since the restoration of Latvia's independence, Latvia has attracted 15,9 billion euros of foreign direct investment. This corresponds to 52.3% of Latvia 's nominal GDP in 2019. Almost 80% of the accumulated FDIs were invested in the share capital of companies and reinvested in the development of the company, in other words, they were no-debt flows. This means that most of the incoming FDIs in Latvia were invested in the company's capital shares, intellectual and real estate. Accumulated FDI in the form of debt instruments has increased from 584 million in 2000 to 3,239 million euro in 2019. However, the share of debt instruments in total accumulated FDI has gradually declined, to 20% in 2019. In 2019, the amount of FDI was 781 million which is broadly in line with the average investment dynamics over the last decade. In 2019, the total inflow of FDI was divided between equity investments (460 mln euros), reinvested earnings (388 mln euros), while the amount of debt instruments was negative (-67 m euros).

In terms of industry, the largest share of accumulated FDI was observed at financial and insurance sectors. Fig. 1 shows the FDI stock in Latvia by kind of activity in millions of euro. In 2019, most or 24.3% of accumulated FDI is concentrated in the financial and insurance sectors, mainly represented by Latvian largest commercial banks in terms of assets, most of which are Scandinavian bank subsidiaries. It should be noted that the share of this sector increased significantly during the period of 2005-2008 and since then steadily boiled in the range of 25%-30%. At that time, foreign direct investment in the financial and insurance sector was on average almost three times higher than in manufacturing. Such large investments in this sector can be explained by potentially high profit opportunities and relatively weak competition from commercial banks owned by Latvian residents.



Source: author's compilation based on Bank of Latvia data

Fig. 1. FDI stock in Latvia by kind of activity, milion euro

In particular, the accumulated FDI in manufacturing accounted for 11.6% of total accumulated FDI in 2019, which mostly concentrated in traditional industries. Manufacturing industry development is one of Latvia's prior industries for attracting FDI. Foreign direct investments inflows in this sector have been relatively stable even in the years of the sharp economic downturn in 2009 and have been growing in recent years, but their share remains virtually unchanged. Assessing the structure of accumulated FDI in manufacturing from a qualitative point of view, it must be concluded that foreign investors invest primarily in low and medium-low technology sectors. The share of accumulated FDI in the high-tech processing industry, such as the manufacture of electrical and optical equipment, machinery and mechanical appliances, pharmaceutical products is only one-fifth. Thus, indicating the low attractiveness of these industries for foreign capital.

The geography of incoming foreign direct investors is wide, however. The largest investments have been received mainly from the Baltic Sea region and countries with which close trade relations have been established, such as the Netherlands, Norway, and Great Britain. The share of EU Member States in total accumulated FDI in Latvia is very high, averaging 71.2% over the last ten years. In recent years, a positively growing trend can be observed in investments from the CIS countries, which is most likely related to the temporary residence permit program implemented in Latvia. However, with the exception of Russia, the share of FDI in other CIS countries is very small.

Repatriation of profits to the investor's country of residence is considered in the scientific literature as a negative factor of FDI, therefore it is important to assess the amount of profits that remained in Latvia and were invested in the company's development and the share of dividends paid to foreign investors. Foreign direct investors received 1,074 million euros in dividends from 2005 to 2008, while the amount of incoming FDI in this period was 4,455 million euros. This means that for every euro invested, an average of 25 cents was paid out to direct investors in the form of dividends. However, from 2011 to 2014, this proportion changed significantly. During this period, approximately 51 cents of each foreign euro were returned to investors. In the period from 2015 to 2019, this proportion continued to increase in favour of dividend payments, and out of each euro invested, an average of 1.38 euro was paid to foreign investors in dividends. The growing amount of dividend payments is related to the amount of accumulated FDI.

The significantly higher amount of dividends paid since 2017 was determined by the significantly higher amount of foreign-related corporate profits in this period. With the gradual improvement of the economic situation, the profits of foreign investors have been steadily increasing, from EUR 80 million in 2010 to EUR 1549 million in 2018 and EUR 1389 million in 2019. The increase in the share of dividends in profit distribution also indicates that the amount of dividends paid has increased since 2017. In 2017, 84% of the profit was paid in dividends and 16% was reinvested in the development of the company. In 2018, this proportion was 78% against 22%, but in 2019 it was 72% and 28%. In the period from 2012 to 2016, or on average over five years, this proportion was 60% and 40%, respectively. However, it should be taken into account that dividends can also be paid for the previous period.

3. Foreign direct investors performance in Latvia

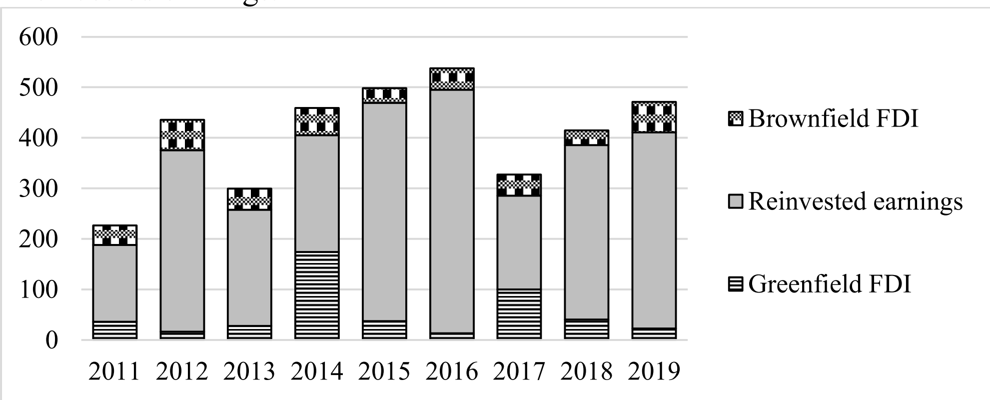
Research methodics

Given that there are no statistics on the establishment of new companies with foreign capital in Latvia (greenfield investments), as well as separate investments of capital increase and mergers and acquisitions (brownfield investment), there is a lack of data to answer the question, whether the current investment environment in Latvia is more favourable for foreign investors to buy local companies or establish new ones. Based on the current 6th edition of the IMF's Balance of Payments and International Investment Position Manual FDI definition and the theory discussed above, the author defined greenfield and brownfield investments as follows. The amount of share capital of a new company was considered to be a greenfield investment. First, when a foreign resident establishes a completely new company in Latvia and all 100% of the company's shares are owned by a foreign investor. In this case, the amount of share capital is greenfield investment. Secondly, when a foreign resident establishes a completely new company in Latvia together with a Latvian resident, but on the condition that the foreign investor owns at least 10% of the company's shares. In the second case, only the part of the share capital that belongs to the foreign resident is considered as FDI. Brownfield investments were considered to be capital increase investments. Capital increase investments can be identified when a foreign resident, invests in a company registered and operating in Latvia, provided that at least 10% of the shares of a company registered in Latvia that were previously owned by a Latvian resident were acquired. Based on this methodology, Lursoft IT Ltd specially selected the necessary data at the request of the author. Further analysis is based on data prepared by Lursoft IT Ltd and Bank of Latvia for period from 2005-2019.

The research data analysis and the discussion of th results

In 2019, 21,228 companies with foreign capital were registered in Latvia. However, only 59% (or 12,435 of the total number) were engaged in economic activity. Most of the companies registered in Latvia with foreign capital are fully owned by foreign residents. At the end of 2019, 74.5% of economically active enterprises in Latvia with foreign capital were fully subsidised by foreign investors. 16.9% of cases, foreign investors held 50% or more of the company's capital shares, but less than 100%. In only 8.6% of cases, these were Latvian and foreign joint ventures, where the share of foreign investor shares ranged from 10 to 50%. In the last 15 years the dominance of foreign investors in companies registered in Latvia with foreign capital increased. Foreign residents are increasingly choosing a corporate governance model where they have full control over the company. On the other hand, the management of companies together with a Latvian resident is not considered to be an attractive company management model.

Regarding greenfield investments, Fig. 2 shows the amount of foreign direct investors' investments in newly established companies in Latvia by years. In 2019, the amount of investments of foreign direct investors in companies established in 2019 was only 22.7 million euro. The volume of this type of investment was also weak in the previous years, thus it can be concluded that the amount of investments in foreign capital of a company established by a foreign investor in Latvia is insignificant compared to the amount of reinvested earnings.



Source: author’s calculations based on SIA “LURSOFT IT” and Bank of Latvia data

Fig. 2. Inflow of greenfield, reinvested earnings and other brownfield investments in Latvia, million euro

If the time factor is applied to greenfield investments and it is assumed that the amount of reinvested earnings within four or five years from the establishment of the company is also greenfield investments (if the company has made a profit during this period), then the total amount of greenfield investments is clearly higher. However, one of the difficulties in analysing greenfield investments is the time factor, namely how long foreign direct investment should be considered as greenfield investments. It is assumed that these may be 4 or 5 years after the establishment of the company, but there is no common methodology of this aspect. Given that there is no common understanding among scientists about the time factor, the author classifies incoming greenfield investments as an investment in the share capital in the year of formation of the company.

Brownfield investments were considered to be capital increase investments. The amount of foreign direct investment with the aim of acquiring at least 10% or more from a company owned by a Latvian resident is quite volatile. In this way, investments became especially popular among foreign investors from 2009. Most likely, this is due to the fact that Latvian companies in difficulty during the crisis opted to choose to sell part or all of their shares to foreign residents, seeing no other opportunity for the company's development. This type of FDI does not create new economic activity. It should be noted that attributing the share of incoming FDI that went to the repurchase of domestic companies against FDIs in share capital, it can be concluded that this type of investment relative to total FDI in share capital has increased over the last 15 years.

The financial crisis of 2008–2010 had a negative impact on economic activity in Latvia, thus the indicators of corporate earnings significantly deteriorated. In 2008, companies that were wholly or partly owned by foreign direct investors suffered increased losses, reaching 600 million euros. That is more than the previous four years combined. In 2009, the amount of losses was even higher and amounted to 672 million euros. From 2010 to 2014, the amount of losses gradually decreased. However, the number of companies that had losses in the reporting year has increased on the contrary (from 4874 companies in 2009 to 5224 companies in 2014). In 2017, the amount of losses in the reporting year reached 695 million euros, but the number of companies operating at a loss increased to 8287. Such results for 2017 and 2018-2019 (as the amount of losses was also significant in those years) can be explained as follows. Assessing the above results, the amount of profit of foreign direct investors (in recent years, foreign investors generally had a record amount of profit), it can be concluded that competition for market shares between foreign companies and local companies, as well as in the attraction of new consumers in Latvia is very high. Thus, there is a relatively large number of companies with foreign capital that operate at a loss in Latvia, do not withstand competition and are unable to successfully exist in the market.

If a company with foreign capital is liquidated or the shares of a foreign resident are repurchased by Latvian residents, it means an outflow of foreign direct investment from the country. If in the early 2000s the outflow of FDI from Latvian-registered companies was small and related to legal factors, namely the protection of investors' rights and the fulfilment of contractual obligations, then in 2008-2010 the determining factor was the overall economic downslide. Starting from 2014, the investment environment both in Latvia and the other Baltic States was negatively affected by the deterioration of the geopolitical situation in the Eastern European region.

In recent years, the largest outflow of FDI from Latvia has been recorded. Thus, in 2018, the amount of outflowing FDI from Latvia amounted to 198 million euros, but in 2019 - 151 million euros. The decision to reduce the share capital or liquidate the company in 2019 was made by a record number of foreign direct investors - 5,669 companies. The author has already pointed out that in recent years, despite the fact that foreign direct investors in Latvia generally worked at a profit, both the amount of losses and the number of companies operating at a loss increased at the same time. Consequently, the growing outflow of foreign direct investment from Latvia in recent years can be explained by a deterioration in profitability. Strong competition, rising labour costs that outpace productivity growth, a shortage of skilled labour and an aging population that narrows potential consumption in the medium and long term are the main reasons why foreign investors decide to leave the Latvian market.

In general, it can be concluded that the volume of greenfield and brownfield investment is rather steady. However, the level of FDI in new projects is lower compared to the amount of reinvested earnings, due to the profit earned from operating activities in Latvia. The hypothesis of research is rejected. Investment environment in Latvia is favourable for FDI.

Conclusions

1. Foreign investors are diverse, and each has its own specific interests. Financial and strategic investors will be interested in completely or partially repurchasing an existing company or bank in order to increase the profit. Risk capital companies and investors invest in information and communications sectors and technological start-ups. Other foreign investors want to buy an existing company that already has a production process and supply chains in place to sell its products on the domestic market. Thus, in order to increase the amount of greenfield investments and encourage foreign investors to reinvest more in the development of companies from the profits earned in Latvia, it is necessary to solve several structural problems.

2. Increasingly, it is not just countries that compete with each other to attract investment, but cities too; for example, when it comes to setting up some shared service centres or business process outsourcing centres. In this area, Riga often has to compete with Prague and other cities in Eastern Europe. The range of available support mechanisms offered to entrepreneurs, including foreign investors, is wide, but the main ones are tax incentives. For example, special economic zones also exist in other EU countries with favourable tax regimes. To attract more FDI, tax support mechanisms alone are not enough. As 55.0% of Latvia's economically active population lives in Riga and Riga Region, it cannot be expected that, with the exception of the Riga region, other regions of Latvia will succeed in attracting FDI, especially to high-tech sectors.
3. In order to improve the investment environment in the Republic of Latvia and increase the inflow of greenfield investments, it is necessary to reduce several obstacles. First, the size of the shadow economy needs to be reduced, as this will not only make economic and business processes more transparent, but will also increase tax revenues, thus increasing the economic flexibility needed to implement structural reforms. Secondly, structural unemployment needs to be reduced through targeted labour market and education system reforms and measures to promote innovation. Third, comprehensive reforms in the education and court system, speeding up court proceedings and legal improvements in the field of insolvency need to be pursued. Energy policy is also one of the topical issues on the agenda of entrepreneurs, as the disproportionately high payment burden of the mandatory procurement component on manufacturing companies does not promote the inflow of new foreign investment into Latvia's manufacturing industry, where FDIs are very important.

References

1. *Annual bulletin Latvia's Balance of Payments.* Bank of Latvia. (2020). Retrieved from https://datnes.latvijasbanka.lv/lmb/LMB_2019.pdf
2. Bank of Latvia, (2020). Balance of Payments (BOP), International Investment Position (IIP) and International Trade in Services (ITS). Retrieved from https://statdb.bank.lv/lb/Data/200
3. Bao, X., Deng., J., Sun, H., & Sun, J. (2022). Trade policy uncertainty and foreign direct investment: Evidence from China's WTO accession. Journal of International Money and Finance, *125.*
4. Bertrand, A. (2004). Mergers and acquisitions, greenfield and extension of capacity. *Direct Investment Technical Group.* Retrieved from https://www.imf.org/external/np/sta/bop/pdf/diteg42829.pdf
5. Blonigen, B. (2005). A review of the empirical determinants of FDI. Atlantic Economic Journal, *33*(1), 383-403.
6. Buckley, P.J., & Casson, M. (2009). Internalisation Theory of the Multinational Enterprise: A Review of the Progress of a Research Agenda after 30 year, *Journal of International Business Studies, 40*(9), 1563-1580.
7. Casson, M. (2000). Enterprise and leadership: Studies on firms, networks and institutions. Cheltenham: Edward Elgar.
8. Chan, C., Makino, S., & Isobe, T. (2006). Interdependent behavior in foreign direct investment. The multi-level effects of prior entry and prior exit on foreign market entry. Journal of International Business Studies, *37*(5), 642-665.
9. Denisia, V. (2010). Foreign Direct Investment Theories: An Overview of the Main FDI Theories. European Journal of Interdisciplinary Studies, *3*, 53-59.
10. Harrison, A., Love I., & Mcmillan, M. (2004). Global capital flows and financing constraints. Journal of Development Economic, *75*(1), 269-301.
11. Hobdari, B., Gammeltoft, P., Li, J., & Meyer, K. (2017). The Home Country of the MNE: The Case of Emerging Economy Firms. Asia Pacific Journal of Management, *34*(1), 1-17.
12. Hyun, H. (2006). Quality of institutions and foreign direct investment in developing countries: Causality tests for cross-country panels. Journal of Business Economics and management, *7*(3), 103-110.
13. Kaushal, L. (2019). Foreign Direct Investment: The Indian Experience. Business Expert Press.
14. Lin, H., & Lin, E. (2010). FDI, trade, and product innovation: Theory and evidence. Southern Economic Journal, *77*(2), 434-464.
15. Liu, X., Parker, D., Vaidya, K., & Wei, Y. (2001). The impact of foreign direct investment on labour productivity in the Chinese electronics industry. International Business Review, *10*(4), 421-439.
16. Liu, X., & Zou, H. (2008), The impact of greenfield FDI and mergers and acquisitions on innovation in Chinese high-tech industries. Journal of World Business, *43*(3), 352-364
17. Luo, Y., & Tung, R. (2018). A general theory of springboard MNEs. Journal of International Business studies, *49*(2), 129-152.
18. Meyer, K. (2004). Perspectives on multinational enterprises in emerging economies. Journal of International Business Studies, *35*(4), 259-276.
19. Nocke, V., & Yeaple, S. (2007). Cross-boarder mergers and acquisitions vs greenfield foreign direct investment: The role of firm heterogeneity. Journal of International Economics, *72*(2), 336-365.

20. Paul, J. Sanchez-Morcilio (2019). Toward a new model for firm internationalization: Conservative, predictable, and pacemaker companies and markets. Canadian Journal of Administrative Sciences, *36*(3), 336-349.
21. Paul, J., & Singh, G. (2017), The 45 years of foreign direct investment research: Approaches, advances, and analytical areas. The World Economy, *40*(11), 2512-2527
22. Schiff, M., & Wang, Y. (2008). North-South and South-South trade-related technology diffusion: How important are they in improving TFP growth? The Journal of Development Studies, *44*(1), 49-59.
23. *Shadow Economy Index for the Baltic Countries.* Stockholm School of Economics. (2020). Retrieved 12 November 2020, from: https://www.sseriga.edu/shadow-economy-index-baltic-countries.
24. Sirr, G., Garvey, J., & Gallagher, L. (2018). Local conditions and economic growth from South-South FDI. The Journal of International Trade & Economic Development, *27*(4), 380-388.
25. Vernon, R. (1966). International investment and international trade in the product cycle, *Quarterly Journal of Economics, 80*(2), 190-207.
26. Yao, S., Wang, P., Zhang, J., & Ou, J. (2016), Dynamic relationship between China's inward and outward foreign direct investments. China Economic review, *40*, 54-70.