

The Impact of Foreign Direct Investments on Export Competitiveness of Companies and Sectors: the Case of Baltic States

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Abstract

The Baltic States belong to a group of „radical reformers” who have successfully conducted their economic, political and social reforms. Since the early 90ties they have chosen the EU markets as their foreign policy orientation. This policy was mainly implemented through the development of trade relations and building of a friendly environment for foreign investors (particularly from the EU), as well as adjustment process to the EU accession. Today most of the finance, telecom and a large part of manufacturing sector are foreign-owned. Overall, FDI has financed around one-fifth of fixed investments. With the relatively high importance of FDI, there has been very little academic research on FDI in the Baltics and their role in export specialization (with certain exceptions in Estonia). The paper attempts to present empirical evidence of the role of FDI in building competitive advantages of companies and sectors of the Baltic States on the EU Single Market in 1992-2003. The remainder of the paper proceeds as follows: Section 1 examines the sector, branch and regional structure of FDI in Baltic States. Section 2 represents the specialization indexes of the Baltic States in trade with the EU in a comparative analysis of Estonia, Latvia and Lithuania. Section 3 analyses the correlation between FDI, specialization and employment in high, medium-high, medium-low and low-tech manufacturing branches in the Baltic States. Finally, Section 4 gives some evidence of the contribution of foreign-owned firms to export competitiveness of the Baltic States to the EU markets. The paper ends with some concluding remarks and policy implications.

Keywords: transition, FDI, trade specialization, competitiveness

JEL Classification: F14, F15, F16

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1 Sector, Branch and Regional Structure of FDI in Baltic States

Small countries like the Baltic States usually attract only small amounts of FDI in nominal terms, which explains the fact that three Baltic countries received about 6-7 percent of FDI inflows into CEE countries, which makes some 1.4 billion USD (2002) (Table 1).

Year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Baltic States	237	398	729	641	973	1799	1031	792	1407	1325
Estonia	156	212	199	111	130	575	222	183	201	364
Latvia	51	155	244	379	515	303	331	153	430	514
Lithuania	30	31	72	151	328	921	478	456	776	447

Source: *The EU Foreign Direct Investment Yearbook 2001*, Eurostat 2002; *World Investment Report 2002*, UNCTAD.

However, this insignificant amount (in international comparison) is very important for the small Baltic economies, and makes some 20-40 percent of gross fixed capital formation and finances a large part of the current account deficit.

It is important to note that Estonia started to receive FDI earlier than Latvia and Lithuania as it was more attractive for foreign investors due to early market reforms. In 2003, the inward FDI stock in Estonia was 70 percent of GDP, twice as high as in Latvia (37.4 percent) and Lithuania (34.5 percent) (Table 2). In all three Baltic countries, the stock of FDI (in percent of GDP) is above the world average.

Year	1992	1994	1996	1998	1999	2000	2001	2002	2003
Estonia	21.0	27.0	27.8	29.4	25.4	51.5	57.2	65.9	69.0
Lithuania	23.0	23.1	23.0	24.3	22.5	20.9	22.2	31.4	34.5
Latvia	11.2	14.9	18.1	20.1	25.0	29.1	30.4	32.4	37.4

Source: *Economist Intelligence Unit 2001*; U. Varblane, *Foreign Direct Investments in the Estonian Economy*, Tartu 2001, p. 59.

More than half of the FDI stock in the Baltic States came from the EU. In 2003 Estonia attracted the highest share of direct investments from the EU – 83.44 percent, in comparison to Latvia - 50.9 percent and Lithuania - 56.2 percent. Moreover, the biggest

part of FDI stems from the Scandinavian and Nordic countries (Sweden, Finland, Denmark).

The sector distribution of FDI reflects the structure of the Baltic economies. As Table 3 shows, service sectors – such as transport, telecommunications, business services, and finance – have attracted the bulk of FDI in the last years of 1995-2003, whereas in the earlier period 1993-1995 most of FDI went to the manufacturing sector (on average in Estonia – 23 percent, Latvia – 20 percent, Lithuania – 26 percent).

Sectors	Estonia		Latvia		Lithuania	
	1995	2002	1995	2002	1995	2002
Manufacturing	45.0	23.0	22.6	20.8	45.0	25.6
Agriculture	5.0	1.6.0	0.2	0.5	4.9	0.5
Trade	24.0	14.0	7.1	14.1	23.9	20.4
Financial intermediation	7.0	23.0	12.8	16.1	-	19.8
Transport and communication	11.0	19.0	31.0	17.4	18.0	18.8
Others	8.0	17.4	26.3	32.1	8.2	14.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: *Foreign Direct Investment 2002*; U.Varblane, *Foreign Direct Investment in the Estonian Economy*, Tartu 2001; *Estonian Statistics 2003*, Monthly No. 4 (136).

Privatization processes, followed by trade liberalization, have become leading factors attracting foreign investors (Linge, 2000). The high share of FDI related to transport, storage and telecommunications is specific to the region. It is due to the transit position of the Baltic countries - from Russia to the EU countries. Financial intermediation is another service sector that has attracted considerable interest of foreign investors. It accounts for 16-28 percent of total FDI. Tallin, the capital of Estonia, is considered to be the financial center of the region. In the banking sector foreign control is almost complete. About 90 percent of the banking assets are held by foreign subsidiaries.

The share of manufacturing in inward FDI stock ranges from 20 percent in Latvia to 26 percent in Lithuania. Most of the manufacturing FDI is in low-tech sectors of wood processing (including paper and furniture), textiles and food. These three industries received almost 40 percent of the manufacturing FDI in Estonia, 55 percent in Lithuania and 47 percent in Latvia in 2002 (Table 4). While the food industry mainly targets the local markets, exports of the wood processing industries are substantial (particularly for Latvia). The chemical industry comes second owing to an oil refinery that refines

Russian oil for export (in particularly in Lithuania and Estonia). Textiles and clothing FDI represents about 10 percent of manufacturing FDI in all three countries. New greenfield investments in this sector are export oriented, especially in Lithuania and Estonia.

Table 4. Structure of manufacturing FDI in Baltic states in 1996 and 2002 in %

Manufacturing branch	Estonia		Lithuania		Latvia	
	1996	2002	1996	2002	1996	2002
Food, beverages and tobacco	31.0	22.6	40.9	42.4	50.9	29.9
Textile and textile products	10.1	13.8	9.0	12.2	12.0	11.9
Leather and leather products	0.6	-	1.4	3.5	0.1	0.04
Wood and wood products (excluding furniture)	0.5	-	0.1	0.1	12.0	17.6
Pulp, paper, publishing and printing	6.0	16.5	4.1	4.8	0.4	0.5
Coke, refined petroleum & nuclear fuel	5.5	-	4.4	4.1	2.0	1.5
Chemicals and man-made fibers	17.6	9.7	14.3	3.4	0.4	0.3
Rubber and plastics	3.0	1.1	1.1	3.9	0.9	1.0
Basic metals and fabricated metals	16.8	-	5.3	6.9	1.8	2.5
Electrical and computer equipment	4.2	3.3	1.2	1.3	1.0	1.8
Optical equipment	5.7	6.2	0.8	0.9	0.3	0.6
Transport, machinery and equipment	4.0	6.9	0.5	5.5	0.1	4.4
Manufacturing (including furniture)	7.2	4.0	1.0	1.3	-	-

Source: Estonian Statistics 1999, Tallin 1999; data from The Latvian Bureau of Statistics, Riga 2003; The Lithuanian Statistical Department, Vilnius 2003; WIIW, Nr. 286 (2002);

Higher value added sectors of machinery, optical, electronic and transport equipment have a combined manufacturing FDI share of more than 14 percent in Estonia but only 7-8 percent in Lithuania and Latvia. Some of the foreign subsidiaries in high-value-added manufacturing have become increasingly export oriented, like the Finish electronic equipment producers in Estonia. The other two countries are still lacking export-oriented investors in high and medium-high tech industries.

2 Trade Specialization of the Baltic States Trade with the EU: Comparative Analysis of Estonia, Latvia and Lithuania

Since 1993 the Baltic States trade with the EU progressed with remarkable speed, both in imports and exports values (Table 5). After trade liberalization and re-orientation, the EU markets (in particularly its Baltic Sea Region members) have become the target markets (UNCTAD, 2003). All three countries have been marked with negative trade balances with the EU during the observed period 1993-2003. A broadly similar picture can be observed in the manufacturing trade as well.

Export	1993	1995	1997	1998	1999	2000	2001	2002	2003
Estonia	43.5	54.7	48.6	55.1	62.8	68.5	69.0	64.3	70.1
Latvia	-	44.2	48.8	56.6	62.6	64.7	59.8	60.6	62.6
Lithuania	21.0	36.4	32.5	38.0	50.1	47.9	49.4	48.4	54.0
Import	1993	1995	1997	1998	1999	2000	2001	2002	2003
Estonia	55.3	66.0	59.2	60.2	57.8	56.1	53.2	55.4	51.3
Latvia	-	49.9	53.1	55.3	53.7	52.4	50.4	54.2	49.4
Lithuania	23.0	37.2	44.3	47.2	46.5	43.6	42.4	46.0	43.0

Source: Foreign Trade 1999; 2000; 2001. Statistical Yearbook on Candidate and South East European Countries, Eurostat 2002; Estonian Statistics 2003, Tallin 2003.

The share of the EU in total manufacturing exports ranged from 41% in Lithuania (in 2000) to 58% in Estonia (in 1999) (Latvia 49%). The trade deficit with the EU was mainly due to a rising surplus in labor- or mainstream goods, such as textiles, wood products and manufacturing (mainly furniture), in case of Lithuania also coke and refined petroleum products. Estonia has significantly improved its export deficit in high-tech products in relations with the EU (in 2002 compared to 1995).¹ This does not concern the other two Baltic countries.

The indicator of the revealed comparative advantage provides a more concise picture of trade specialization. The RCAs presented in Table 6 indicate that Estonia has achieved revealed comparative advantage in trade with the EU in: textiles, wood products and furniture. There was one branch where Estonia saw a drop in the RCA index in 1995

¹ See Hunya (2002).

compared to 1992: food sector, which has developed mainly due to the inflows of FDI (the share of FDI amounted to 20-30% in 1995).

Table 6. **Revealed comparative advantage (RCA) of Estonian manufacturing trade with the EU in the years 1992, 1995, 1999, 2003**

RCA in trade with the EU		1992	1995	1999	2003
Year					
I	Food products, beverages and tobacco	0.33	0.11	-0.40	-0.15
II	Textile and textile products	0.25	0.26	0.43	0.45
III	Leather and leather products	-	-	-	-
IV	Wood and wood products (excluding furniture)	-	-	2.00	1.62
V	Pulp, paper & paper products, publishing and printing	0.25	0.90	-0.43	-0.13
VI	Coke, refined petroleum products & nuclear fuel	-0.24	-0.34	-1.07	-0.79
VII	Chemicals, chemical products and man-made fibers	-0.29	-0.19	-0.68	-0.56
VII	Rubber and plastic products	-	-	-0.98	-0.91
IX	Basic metals and fabricated metal products	0.10	-0.05	-0.14	-0.13
X	Electrical and optical equipment	-0.75	-0.50	-0.03	-0.08
XI	Transport, machinery and equipment	-0.15	-0.13	-1.01	-1.27
XII	Manufacturing (including furniture)	0.68	0.67	1.37	1.72

Source: own calculations based on formula $RCA_j = \ln [x_j / m_j : \Sigma x_j / \Sigma m_j]$, where x – export, m – import, j – selected product group and data from Statistikaamet, Tallin 1993r.; Eesti Pank, Annual Report 1994; Foreign Trade: Lithuania, Latvia, Estonia 1999, 2001, 2003.

Despite a significant inflow of FDI into petroleum and chemical, computer and electrical equipment industries these branches show no improvements in trade relations with the EU. In comparison to Estonian bilateral relations with Finland and Sweden (its main trade partners) some positive results can be observed. Starting from 1997, apart from the traditional branches (textiles, wood products), Estonia has been observing positive RCAs in electrical, communication and optical equipment trade with Finland. Similar effects have been noticed with Sweden since 2002.

Lithuania's competitive position in trade with the EU measured by RCA index improved as well in 1995-2003 compared to the period 1992-1995. Similarly to Estonia, there were few branches where Lithuania had a positive comparative advantage: textiles (the highest RCA among Baltic States), leather, wood, coke and refined petroleum products and furniture (Table 7).

In bilateral relations with its main partners – Great Britain, Denmark - Lithuania has also observed RCA improvements, apart from its traditional branches - wood, textiles, refined

petroleum products (with the exception of Denmark in 1997), in electrical and transport equipment (with the exception of Great Britain).

Table 7. Revealed comparative advantage (RCA) of Lithuanian manufacturing trade with the EU in the years 1992, 1995, 1999, 2003

RCA in trade with the EU		1992	1995	1999	2003
	Year				
I	Food products, beverages and tobacco	-1.04	0.01	-0.48	-0.08
II	Textile and textile products	0.02	0.52	0.88	0.82
III	Leather and leather products	0.53	0.48	0.94	0.57
IV	Wood and wood products (excluding furniture)	0.81	2.26	2.53	2.28
V	Pulp, paper & paper products, publishing and printing	-0.89	-0.63	-2.40	-2.99
VI	Coke, refined petroleum products & nuclear fuel	2.63	-0.56	0.26	3.26
VII	Chemicals, chemical products and man-made fibers	0.51	0.26	0.02	-0.41
VIII	Rubber and plastic products	-0.08	-0.54	-1.31	-1.56
IX	Basic metals and fabricated metal products	1.04	-0.02	-0.53	-0.84
X	Electrical equipment	-1.66	-0.34	-0.69	-0.97
XI	Optical equipment	-1.34	-0.77	-1.11	-0.77
XII	Transport, machinery and equipment	-0.82	-0.46	-0.87	-0.99
XIII	Manufacturing (including furniture)	-0.56	0.38	0.97	1.61

Source: own calculations based on formula $RCA_j = \ln [x_j / m_j : \Sigma x_j / \Sigma m_j]$, where x – export, m – import, j – selected product group and data from Lietuvos Statistikos Departamento, Vilnius 1993; Foreign Trade: Lithuania, Latvia, Estonia 1999, 2001, 2003.

The RCAs for Latvia presented in Table 8 indicate that the country has achieved the highest comparative advantages in wood products (among Baltic States in 2003), refined petroleum products, basic metals, leather products and textiles. Positive RCAs have also been observed with Latvia's two main EU partners – Germany and Sweden (about 40-50% of total turnover with the EU in 2003). The advantages with Germany have been achieved due to growing exports of wood products and textiles. A deteriorating trade competitiveness can be observed in trade relations with Sweden, in particularly in exports of textiles, wood products and furniture, yet there have been remarkable improvements in trade relations with Denmark (due to exports of transport equipment).

Table 8. Revealed comparative advantage (RCA) of Latvian manufacturing trade with the EU in the years 1992, 1995, 1999, 2003

RCA in trade with the EU					
	Year	1992	1995	1999	2003
I	Food products, beverages and tobacco	-0.60	-0.86	-1.72	-0.99
II	Textile and textile products	2.89	0.53	1.18	0.54
III	Leather and leather products	1.2	-	0.89	0.86
IV	Wood and wood products (excluding furniture)	3.68	1.95	4.31	4.11
V	Pulp, paper products, publishing and printing	-1.70	-	-2.41	-2.41
VI	Coke, refined petroleum products & nuclear fuel	-	-	0.76	0.56
VII	Chemicals, chemical products, man-made fibers	-1.69	0.34	-1.51	-2.04
VIII	Rubber and plastic products	-0.72	-	-2.12	-1.38
IX	Basic metals and fabricated metal products	0.21	1.93	0.16	0.72
X	Electrical equipment	-2.89	-1.51	-1.89	-1.96
XI	Optical equipment	-1.40	-	-2.12	-2.41
XII	Transport, machinery and equipment	0.21	0.66	-2.41	-3.22
XIII	Manufacturing (including furniture)	2.60	1.66	1.08	0.95

Source: own calculations based on formula $RCA_j = \ln [x_j / m_j : \sum x_j / \sum m_j]$, where x – export, m – import, j – selected product group and data from Latvian Statistical Office, Riga 1993; Foreign Trade: Lithuania, Latvia, Estonia 1999, 2001, 2003..

The export of the Baltic States on the EU markets consists of intra-industry trade (over 60% in 2003). This confirms that their export specialization is based on similar goods with relatively different quality (Table 9).

Table 9. Intra-industry trade (IIT) indexes for Baltic states with the EU (2003)

	Estonia	Lithuania	Latvia
I Food products, beverages and tobacco	0.61	0.83	0.59
II Textile and textile products	0.84	0.74	0.95
III Leather and leather products	0.72	0.67	0.79
IV Wood and wood products (excluding furniture)	0.15	0.25	0.06
V Pulp, paper & paper products, publishing and printing	0.58	0.08	0.17
VI Coke, refined petroleum products & nuclear fuel	0.87	0.10	0.92
VII Chemicals, chemical products and man-made fibers	0.31	0.67	0.28
VIII Rubber and plastic products	0.44	0.78	0.16
IX Basic metals and fabricated metal products	0.77	0.50	0.28
X Electrical equipment	0.93	0.45	0.87
XI Optical equipment	0.99	0.52	0.17
XII Transport, machinery and equipment	0.36	0.04	0.08
XIII Manufacturing (including furniture)	0.46	0.55	0.75

Source: own calculations based on the formula $IIT = \frac{Export\ j + Import\ j - Export\ j + Import\ j}{Export\ j + Import\ j}$, where j – denotes the particular product or group of commodities. The indexes values vary from 0-1 and indicate the intensity of the intra-industry trade. Source of data: The Statistical Office of Estonia; Lithuanian Department of Statistics; Latvian Statistical Office.

We can see that the highest IIT indexes in the Estonian trade with the EU have been in selected technology-driven (electrical and optical equipment), capital-intensive (petroleum and metals), marketing-driven (food and beverages) as well as labor-intensive products (textiles, leather)². Lithuania's intra-industry trade specialization is the most intensive in labor-intensive products (textiles, wood, leather) and partly capital-intensive products (chemicals). There was a drop in specialization indexes in refined petroleum products, which was caused by a decreasing import from the EU in the last years 2002-2003. The structure of IIT indexes for Latvia looks similarly to that of the previous two Baltic countries. It has a dominant specialization in labor-intensive, capital-intensive products as well as technology-driven ones (due to increasing imports from the EU of electrical equipment, machinery, radio and communications equipment).

The level of intra-industry trade indicates the structural differences between the Baltic States and the EU. In 2002 the average level of this index amounted to 0.62% for Estonia, 0.47% for Lithuania and 0.46% for Latvia.

3 FDI, Employment and Trade Specialization

The regression analysis between RCAs and manufacturing FDIs in high, medium-high, medium-low and low-tech industries in the Baltic States revealed their positive correlations. The function of regression is defined as $RCA_t = mFDI_t + nEI_t + b$ (t - selected year), where EI is the employment rate in high, medium-high, medium-low and low-tech industries. The data covered the period 1994-2003 for the three Baltic States. For ease of interpretation, it was considered that the impact of independent variables (FDI and EI) on the dependent ones (RCA) is equal in all groups (Weresa, 2001).

The regression model for Estonia indicates that its comparative advantages measured by RCA in the period t had a low dependence on FDI and employment rates. The closest to the desirable level was medium-low-tech industry (production of transport equipment) and low-tech (production of refined petroleum products, wood products and furniture). Relatively high correlation was observed for the high-tech industry (production of communications equipment). In the case of Lithuania the highest correlation was observed in the case of medium-high-tech industry (production of machines and electrical equipment), and medium-low-tech industry (production of rubber and plastics).

² See Varblane (2000).

The correlation in low-tech industry covers mainly textile production. There was a low correlation between RCA and FDI in the high-tech industry. The correlation results for Latvia indicate a strong dependence of RCA on FDI inflows and employment in high-tech (production of communications equipment) and medium-high-tech industries (electrical machines and equipment).

The test of significance (t-Student) confirms (with probability of error at 5 percent) the significance of FDI in explaining the comparative advantages in Estonia in the medium-high-tech industry, in Lithuania in the medium-high, medium-low and low-tech industries and in Latvia in high-tech and medium-high-tech industries. Changes in employment had similar impact on RCAs in the mentioned industrial branches.

Summing up, the analysis of regression revealed different results for each country. Estonia and Lithuania observed the lowest correlation among the Baltic States between comparative advantages, manufacturing FDIs and employment rates. However, it is important to note that the results of regression could differ a lot if they were based on the bilateral trade-investment correlation – for example on the Estonian-Finish relations.

4 The Importance of Foreign Owned Companies in Developing Export Competitiveness. Role of Technology-transfer and Investments into R&D

Empirical evidence from broad-based country studies suggests that FDI has a positive impact on economic growth, restructuring and competitiveness – both directly through transfer of capital and knowledge to foreign-owned companies and indirectly through spillovers to the domestic sector (Hunya, 2004). The data showing the share of foreign-owned companies in output, exports and employment are not available from statistical offices (with the exception of Estonia). The author's own survey on a small sample of 108 firms acting in Baltic States (2003/2004). In Estonia there were 24 firms (foreign-owned companies made 33 percent and domestic 67 percent), in Lithuania 50 firms (foreign-owned made 54 percent and domestic ones 46 percent) and in Latvia 34 firms (foreign owned made 44 percent and domestic ones 56 percent). Some 54 percent of Estonian foreign-owned firms (telecommunications and electrical equipment), 38 percent of Lithuanian foreign-owned firms (food, tobacco and electrical equipment) and 38 percent of Latvian foreign-owned firms (electrical and telecommunications equipment) have exported their goods to the EU markets. Some 81 percent of Estonian, 100 percent

of Lithuanian and 84 percent of Latvian companies have significantly improved the quality of their products (Table 10).

Table 10. **Share of firms which introduced new products or used improved technological systems of production**

% companies	Domestic firms						Foreign-owned firms					
	Estonia		Lithuania		Latvia		Estonia		Lithuania		Latvia	
		%		%		%		%		%		%
Improved products	5	63	14	52	12	80	12	81	21	100	16	84
Improved systems of production or technology	3	37	18	67	9	60	9	56	18	78	15	79
Have quality certificates ISO 9001 ISO 14000 Other System of quality control	8	100	18	67	13	87	16	100	13	62	14	73

Source: author's own survey.

These changes were observed in most of the foreign-owned companies (63 percent of Estonian, 52 percent of Lithuanian, 80 percent of Latvian). Some 56 of Estonian, 78 percent of Lithuanian and 79 percent of Latvian foreign-owned companies received technological know-how from the mother companies.

Survey showed that FDI also strengthened the host countries' export potential by increasing company investments into R&D. Activities related to R&D were conducted by 68 percent of foreign-owned and 63 percent of domestic Estonian companies, 69 percent of foreign-owned and 77 percent of domestic Lithuanian companies, and 89 percent foreign-owned and 73 percent of domestic Latvian companies. Survey showed that in all three countries foreign-owned companies aimed to meet the local consumers needs, whereas in domestic companies R&D activities aimed at new management and production solutions. Moreover, R&D activity in foreign-owned companies was concentrated mainly in the smallest (up to 50 employees) and the largest firms (more than 500 employees) (with the exception of Latvia). These companies have spent on average 4-5 percent and 3-4 percent of their total turnovers, whereas domestic companies have spent only 1-3 percent.

Another survey based on a larger sample of Estonian companies (1999) proved that foreign-owned companies (over 50 percent of foreign capital) in low-tech and high-tech

industries achieve 40-50 percent better productivity and larger exports per employee. Such data is, however, not available for the other two countries – Latvia and Lithuania.

5 Concluding Remarks and Policy Implications

In 1992-1995 major part of FDI went to manufacturing sector, while in the last years 1995-2003 most of FDI has been directed to services. Manufacturing FDI went mainly into low-tech industries. FDI has reinforced the given economic structure and has not generated much structural change. Latvia and Lithuania with their export-oriented FDI in textiles, wood products and refined petroleum products are more similar to other less developed transition countries. Estonia has succeeded more than the other two countries in attracting export-oriented transnational corporations specializing in high-tech products.

FDI can strengthen manufacturing and services functions for the regional market. However, the extent of the FDI impact on the country's specialization depends also on other policies enhancing the FDI inflows, technological learning and spillover effects in the national companies.

The Baltic States should continue to absorb a fair amount of international FDI flows. The transit role of the Baltic States for the EU and Russia should attract substantial international FDI inflows to the Baltics. Finally, one of the important policies affecting the FDI inflows into high-tech industries of the Baltic States are their long-term innovation and competitiveness strategies, which will facilitate further catching-up processes, improve their long-term export competitiveness and develop their national specialization in the EU markets.

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