



## FACTOR ANALYSIS OF LITHUANIAN AND ESTONIAN INWARD FOREIGN DIRECT INVESTMENT

Mantas Degutis<sup>1</sup>, Manuela Tvaronavičienė<sup>2</sup>

*Vilnius Gediminas Technical University, Saulėtekio al. 11, 10223 Vilnius, Lithuania*

*E-mail: <sup>1</sup>mantasdegutis@yahoo.ca; <sup>2</sup>manuela@vv.vtu.lt*

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**Abstract.** The paper examines trends of foreign direct investments (FDI) in the Baltic States and macroeconomic factors causing FDI flow from capital exporting countries to host economies. Authors analyze the conditions under which FDI is likely to replace export or import. Questions, how FDI adds up to GDP growth, how labor costs affect decision to start foreign investment, to which extent tax burden suspends FDI are tackled. A simplified statistical model, which determines causal relationship between macroeconomic variables and inward FDI to Lithuania and Estonia is used. Data range comprises Lithuanian GDP, foreign trade, taxes, labor costs and productivity over the last decade. Authors formulate policy implications in order to increase efficiency of FDI regulation in Lithuania.

**Keywords:** foreign direct investments, development, factors.

### 1. Introduction

The article deals with factors affecting inward foreign direct investment from capital exporting countries. Revealed relationship would facilitate formulation of more efficient economic policy. The aim of this article is to clarify, whether Lithuanian economic situation is unique from the point of view of inward FDI, or it could be treated as corresponding to some consistent pattern of development. This will be done by testing influence of particular macroeconomic variables on inward FDI. In order to find the most important factors affecting FDI inward stocks in Lithuania, we will ground theoretically which statistically measurable macroeconomic indicators could be used in the analysis.

In order to reveal similarities and differences of comparatively similar Baltic countries, Estonian inward FDI are to be analyzed as well. Estonia was chosen as it displays slightly different tendencies of FDI comparing them to Lithuania. Latvian FDI change mode has many similarities with Lithuanian one. Authors strive to identify and interpret differences of FDI trends in Baltic States.

Vast majority of studies on FDI emphasize an impact of FDI on economic growth and technological advancement. Analysis of factors or driving forces of FDI causing inflows of foreign capital into host country is seen as an

other facet of the same issue. Factors initiating arrival of FDI embrace macroeconomic performance, business conditions, and also the socio-political environment [1].

P. Nunnenkamp (2002) analyses the issue in a wider perspective and assesses the impact of globalization on the determinants of FDI in developing countries. This study replicates that the traditional market-related determinants, i.e., macroeconomic variables, business conditions and other socio-political and environmental factors, are still dominant factors. The study also discovers that, among non-traditional FDI determinants, only the availability of local skills has clearly gained importance [2].

Although there have been many studies investigating the influence of factors affecting FDI, the study of Lithuanian case was not carried out properly. Based on research hypotheses, which were tested in a wide range of countries with different economic situations, this investigation concentrates especially on Lithuania. In order to have a more thorough impression about the Baltic region, authors tackled Estonian FDI as well. Estonia, as object of the analysis has been chosen as it displays different behavior of FDI compared to Lithuania. Latvian FDI behavior has many similarities to Lithuanian one. This work is done by analyzing Lithuanian and Estonian macroeconomic variables, discovering their meaningful relations to FDI and explaining the possible reasons in the perspective of time.

## 2. Export and Import Analysis in Respect of Inward FDI

In general, the more technology-intensive the multinational enterprise, the more the multinational enterprise imports from the source country, largely due to the absence of local suppliers. However, this large technology gap pushes multinationals to increase exports given by the lack of local demand, particularly in developing countries [3].

**Hypothesis 1.** *The exports and imports reflect the openness of the economy. The higher these indicators are, the more liberalized the economy is expected to be; this will have a positive impact on the FDI inflow. Therefore, the impact of these variables on FDI is positive.*

Fig 1 represents dynamics of Lithuanian and Estonian export, import and inward FDI stocks. This is a graphical form of the data used in determining correlation coefficients and statistical significance. As we see from this figure, both import and export of Lithuania grew constantly, starting with data from 1996 and ending in 2004, except the decrease in 1999. Foreign trade in that year was limited by the Russian crisis, which started in August of 1998, but after that we see a recovery and growth again. However, Russian crisis did not directly affect inward FDI stocks to Lithuania. According to the 1<sup>st</sup> hypothesis, the lower indicators of the foreign trade in 1999, the less investment Lithuania should have gained. Obviously, it is not true for a short period of time.

Speaking about Estonia, the decrease of foreign trade in 1999 did not recover for a longer period of time in comparison with Lithuania. On the other hand, Estonian balance of trade shows better results than Lithuanian one: Estonian import and export are at about the same level, while Lithuania experiences the bigger share of exports than imports over the past nine years. Concerning FDI inward stocks to Estonia in the period of 1999–2000, we see only a very small growth compared to Lithuanian FDI at the same time.

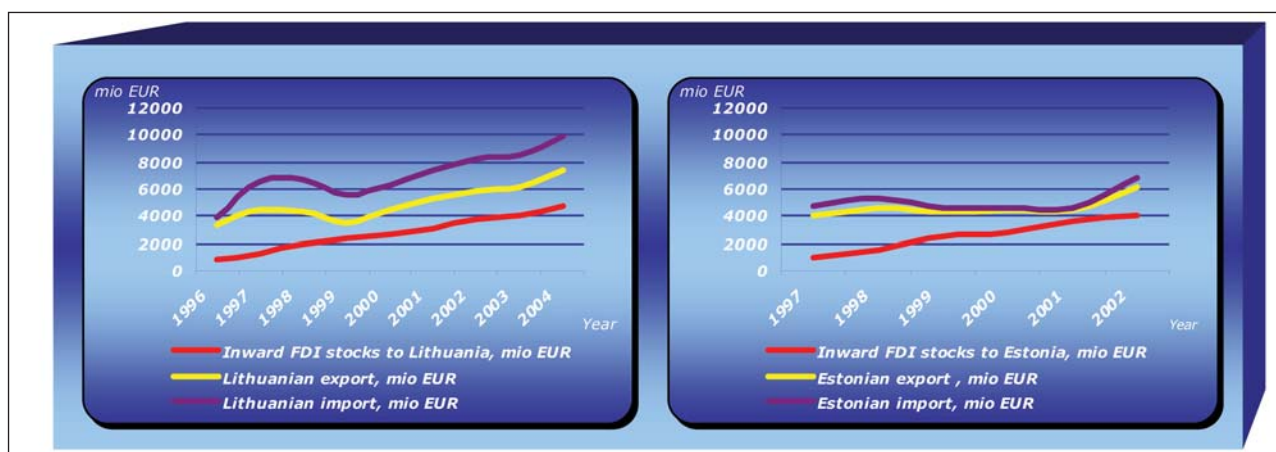
The results of the correlation analysis between export/import and FDI inward stocks are surprisingly different for Lithuania and Estonia and they are submitted in Table 1.

At first sight correlation coefficients seem to be significant for almost all variables and that would prove the 1<sup>st</sup> hypothesis. In order to determine the significance of each variable used in the analysis, Student's *t*-distribution is taken into consideration and also absolute values for each time series are calculated. Probability associated with the two-tailed Student's *t*-distribution here is 0,05 and number of degrees of freedom to characterize the distribution are 7 and 4 for Lithuania and Estonia accordingly. The results show that for Lithuanian inward FDI stocks export is a significant determinant because *t*-observed is greater than *t*-statistics. For Estonian inward FDI stocks export seems to be not significant because *t*-observed is smaller than *t*-statistics. Speaking about import, as one of the causing FDI factors, similar results are got from the correlation analysis: import is a significant determinant for Lithuania but not meaningful for Estonia.

The 1<sup>st</sup> hypothesis is proved for the case of Lithuania but denied for Estonia. To be more precise, other things being equal, Lithuanian export and import reflect the openness of the economy and at this point have positive impact on the FDI inward stocks to Lithuania. Speaking about

**Table 1.** Correlation coefficient, *t* value and *t* statistics for export and import to inward FDI stocks for Lithuania and Estonia

Country	r	t-observed	t-statistics
Export to FDI inward stocks			
Lithuania	0,89	5,18	2,36
Estonia	0,67	1,80	2,78
Import to FDI inward stocks			
Lithuania	0,90	5,46	2,36
Estonia	0,49	1,13	2,78



**Fig 1.** Dynamics of Lithuanian and Estonian Export, Import and Inward FDI stocks

Sources: Lithuanian Department of Statistics, EUROSTAT

Estonia, other things being equal, export and import, surprisingly, do not seem to be having a positive impact on FDI inward stocks to Estonia. On the other hand, low data availability restricts carrying out in-depth analysis, which could show different results. Moreover, foreign trade, expressed in terms of export and import, is not the single determinant in attracting FDI to the country; therefore, more factors will be analyzed further in this work in order to obtain a more sophisticated view of Lithuanian FDI in comparison to Estonian FDI.

### 3. Market size Analysis in respect of Inward FDI

The size of the economies or GDP is likely an indicator of potential market size and, hence, encourages trade rather than FDI [4]. This part of the work will analyze if there exist any relations between country's Gross Domestic Product and FDI inward stocks to Lithuania and Estonia.

**Hypothesis 2.** *The GDP level of the host country reflects the purchasing power of a country and also represents its market capability. Consequently, it is expected to have a positive impact on the FDI inflows.*

Fig 2 represents dynamics of Lithuanian and Estonian GDP and inward FDI stocks. This is a graphical form of the data used in determining correlation coefficients and statistical significance. As we see from this figure, both GDP and inward FDI stocks grew constantly, starting with data from 1996 and ending in 2004, except the stagnation in 1998–1999. Foreign trade in that time was limited by the Russian crisis and that affected the growth of both Lithuanian and Estonian GDP. Later on we see a constant growth again. However, Russian crisis did not directly affect inward FDI stocks to Lithuania.

Concerning FDI inward stocks to Estonia in the period of 1999–2000, we see only a very small growth compared to Lithuanian FDI at the same time. Moreover, the graph shows that inward FDI takes much bigger share in Estonian GDP than in Lithuanian over the last decade. As fol-

lows, Lithuanian GDP is boosted by other factors rather than inward FDI.

The results of the correlation analysis between GDP and FDI inward stocks are given in a Table 2.

Correlation coefficients seem to be significant for all variables and that proves the 2<sup>nd</sup> hypothesis. In order to determine the significance of each variable used in the analysis, Student's *t*-distribution is taken into consideration and also absolute values for each time series are calculated. Probability associated with the two-tailed Student's *t*-distribution here is 0,05 and number of degrees of freedom to characterize the distribution are 7 and 4 for Lithuania and Estonia accordingly. The results show that for Lithuanian inward FDI stocks, GDP is a significant factor because *t*-observed is greater than *t*-statistics. For Estonian inward FDI stocks export seems to be significant as well because *t*-observed is much greater than *t*-statistics.

The 2<sup>nd</sup> hypothesis is proved for both cases: Lithuanian and Estonian. Speaking generally, other things being equal, the GDP level of the host country reflects the purchasing power of a country and also represents its market capability, therefore GDP level has positive impact on the FDI inward stocks to Lithuania. Speaking about Estonia, the same results are obtained from the correlation analysis.

On the other hand, inward FDI boosts country's GDP and accounts for the foreign debt's share in the GDP structure. Consequently, the question arises, either GDP growth causes FDI inflows, or FDI determines GDP growth. However, it is proved that these two variables are strongly cor-

**Table 2.** Correlation coefficient, *t* value and *t* statistics for GDP to inward FDI stocks for Lithuania and Estonia

Country	r	t-observed	t-statistics
GDP to FDI inward stocks			
Lithuania	0,97	11,33	2,36
Estonia	0,98	8,96	2,78



**Fig 2.** Dynamics of Lithuanian and Estonian GDP and Inward FDI stocks, mio EUR

Sources: Lithuanian Department of Statistics, EUROSTAT



related with each other and a country's wealth, in any case, is a significant factor in terms of attracting investment.

**4. Labor Force Analysis in Respect of Inward FDI**

This part of the work analyses certain labor force issues, which are expected to have impact on FDI inward stocks to Lithuania. These issues are labor productivity and labor costs.

**Labor productivity.** Public policy has in several countries impacted positively upon human resource development in the context of inward investment. Human resources have more often been developed not so much by the multinationals but rather by domestic governments themselves as a way of attracting that inward investment. Thus rather than inward investment enhancing human capital, the causal process has been the enhancement of human capital to attract inward investment [5].

**Hypothesis 3.** *The labor force is one of the important inputs in the production process. An increase in its productivity will improve the production capability of firms. Thus, I hypothesize that the productivity of the labor force in Lithuania shall have a positive impact on the FDI inflows.*

Fig 3 represents growth of Lithuanian and Estonian labor productivity, expressed in Purchasing Power Standards, and inward FDI stocks, measured in millions Euros. The following figure is a graphical form of the data used in determining correlation coefficients and statistical significance. As we see from the chart, both labor productivity and inward FDI stocks grew constantly, starting with data from 1996 and ending in 2004 for Lithuania, and for Estonia available data is for the years 1997–2002. Labor productivity per person employed in Lithuania has reached the lower level than Estonian for the same period. On the other hand, Lithuania showed more intensive growth than Estonia. Labor productivity in Lithuania decreased starting with the year 1998 and recovered to the same level

only in the year 2000, while Estonia during the same period showed the constant growth. Afterwards, Lithuania continued on improving labor productivity, while Estonia kept the same level for one year.

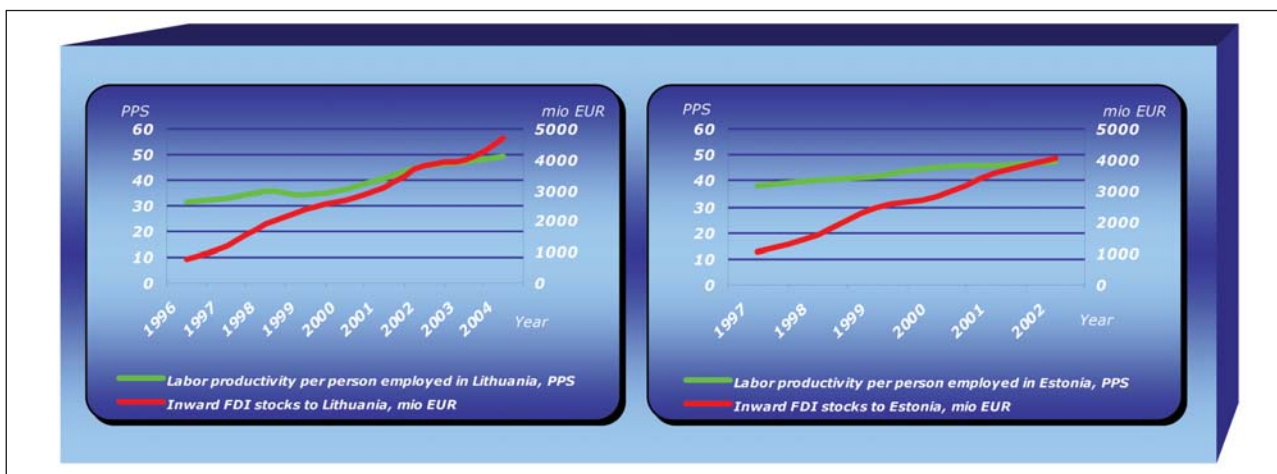
The results of the correlation analysis between GDP and FDI inward stocks are given in Table 3.

Correlation coefficients are significant for both countries and that proves the 3<sup>rd</sup> hypothesis. In order to determine the significance of each variable used in the analysis, Student's *t*-distribution is taken into consideration and also absolute values for each time series are calculated. Probability associated with the two-tailed Student's *t*-distribution here is 0,05 and number of degrees of freedom to characterize the distribution are 7 and 4 for Lithuania and Estonia accordingly. The results show that for Lithuanian inward FDI stocks, labor productivity per person employed is a significant factor because *t*-observed is greater than *t*-statistics. For Estonian inward FDI stocks labor productivity per person employed seems to be significant as well because *t*-observed is much greater than *t*-statistics.

The 3<sup>rd</sup> hypothesis is proved for both cases: Lithuanian and Estonian. Consequently, labor productivity is one of the indicators reflecting human resource competitiveness, which, in turn, plays a significant role in deciding whether to invest or not. It follows, that growing production capabilities of the firms, other things being equal, have direct relation to the growth of FDI inward stocks. Speaking about Estonia, the similar results are obtained from the correlation analysis. To be more precise, Estonia showed the higher

**Table 3.** Correlation coefficient, t value and t statistics for labor productivity to inward FDI stocks for Lithuania and Estonia

Country	r	t-observed	t-statistics
Labor productivity per person employed to FDI inward stocks			
Lithuania	0,96	9,24	2,36
Estonia	0,98	9,57	2,78



**Fig 3.** Growth of Labor productivity and FDI Inward stocks in Lithuania and Estonia

Sources: Lithuanian Department of Statistics, EUROSTAT

level of labor productivity over the time and, consequently, discovered stronger relation to incoming FDI.

On the other hand, the reverse conclusion could be drawn from the analysis. It is proved that FDI can be an important source for productivity growth and encourage transformation process in transition countries [6].

**Labor costs.** In the expanded EU25, Lithuania, together with the two other Baltic countries – Latvia and Estonia – offers the cheapest labor force for the export-oriented FDI. Average monthly wages in Lithuania's manufacturing sector amount to about 350–400 Euros per month – significantly lower than in the high-income EU members. However, unless labor productivity is at a high level, the low labor cost loses its competitive advantage [7].

**Hypothesis 4.** *An increase in the wage rate will increase the cost of production. Therefore, I hypothesize that the wage rate shall have a negative impact on the FDI inflows to Lithuania.*

Fig 4 represents the dynamics of Lithuanian and Estonian hourly labor costs, expressed in Euros, and inward FDI stocks, measured in millions of Euros. The following figure is a graphical form of the data used in determining correlation coefficients and statistical significance. As we can see from the chart, both labor costs and inward FDI stocks grew constantly, starting with data from 1996 and ending in 2004 for Lithuania, and for Estonia available data is for the years 1997–2002. Labor costs per hour worked in Lithuania accounted for the lower level than Estonian for the same period. On the other hand, Lithuania showed more intensive growth than Estonia in 1999–2000. Starting with the year 2000, a more rapid growth in Estonia than in Lithuania is observed.

The results of the correlation analysis between hourly labor costs and FDI inward stocks are given in Table 4.

Correlation coefficients are very significant for both countries. In order to determine the significance of each

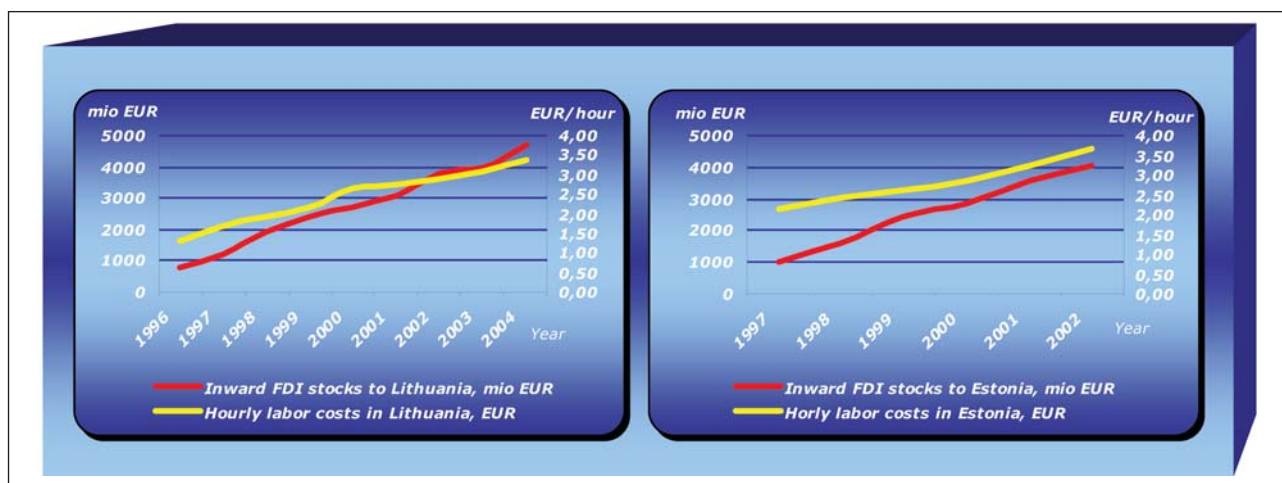
variable used in the analysis, Student's *t*-distribution is taken into consideration and also absolute values for each time series are calculated. Probability associated with the two-tailed Student's *t*-distribution here is 0,05 and number of degrees of freedom to characterize the distribution are 7 and 4 for Lithuania and Estonia accordingly. The results show that for Lithuanian inward FDI stocks, labor costs per hour worked is a significant factor because *t*-observed is greater than *t*-statistics. For Estonian inward FDI stocks labor costs per hour worked seems to be significant as well because *t*-observed is much greater than *t*-statistics.

Consequently, the 4<sup>th</sup> hypothesis has to be rejected for both Lithuania and Estonia. Correlation analysis showed a very strong positive relationship between the variables, although the opposite result was expected to take place. It follows that the higher the wage rate, the more inward FDI country receives. The explanation of this tendency covers the overall level of the economy: if a host country is competitive, has developed infrastructure and favorable business environment, it is also capable to sustain the growth and development. To be more precise, low wages are associated with unskilled labor and low productivity and that reduces the level of inward FDI over a long period.

To conclude the labor force analysis in respect of inward FDI, it is worth to mention that in order to develop rapidly, a country has to increase both its average wage rate and its productivity.

**Table 4.** Correlation coefficient, *t* value and *t* statistics for hourly labor costs to inward FDI stocks for Lithuania and Estonia

Country	r	t-observed	t-statistics
Hourly labor costs to FDI inward stocks			
Lithuania	0,99	15,49	2,36
Estonia	0,98	9,10	2,78



**Fig 4.** Dynamics of Lithuanian and Estonian hourly labor costs and Inward FDI stocks

Sources: Lithuanian Department of Statistics, EUROSTAT

### 5. Tax Burden Analysis in Respect of Inward FDI

This part of the work will analyze, if there exist any relations between country's tax burden and FDI inward stocks to Lithuania and Estonia [8]. Due to restricted availability of data, taxes on production and imports are chosen to reflect the tax burden.

In order to determine if there exists a relation between tax burden and inward FDI stocks, it is necessary to test the 5<sup>th</sup> hypothesis which sounds as follows:

**Hypothesis 5.** *Let's assume that taxes on production and imports reflect the tax burden. The lower tax rate will attract more foreign investors into Lithuania. Therefore, lower taxes are expected to have a positive impact on FDI.*

Fig 5 represents the dynamics of Lithuanian and Estonian taxes on production and imports, expressed in percentage of GDP, and inward FDI stocks, measured in millions of Euros. The following figure is a graphical form of the data used in determining correlation coefficients and statistical significance. As we can see from the chart, the taxes on production and imports decreased, while the inward FDI stocks increased for the same period of time. The highest tax rate in the past decade for Lithuania and Estonia was in 1997. Afterwards it started decreasing. The dynamics of taxes curves for Lithuania and Estonia differs. Lithuanian tax decrease is observed in 1997–1998, later tax rate was constant for one year, after that was a decrease again until 2001, and a slight rise for a short term, and after the year 2002 tax rate on production and imports was reduced. Speaking about Estonia, a constant decrease of tax rate is observed from 1997 to 1999, later there was a recovery for one year at the level of the year 1998, afterward a slight decrease and a very small increase again. Data for Estonia is available only until the year 2002, but we can assume that there should have been a tax rate reduction after 2002 due to approaching accession to the EU.

The results of the correlation analysis between hourly

labor costs and FDI inward stocks are given in Table 5.

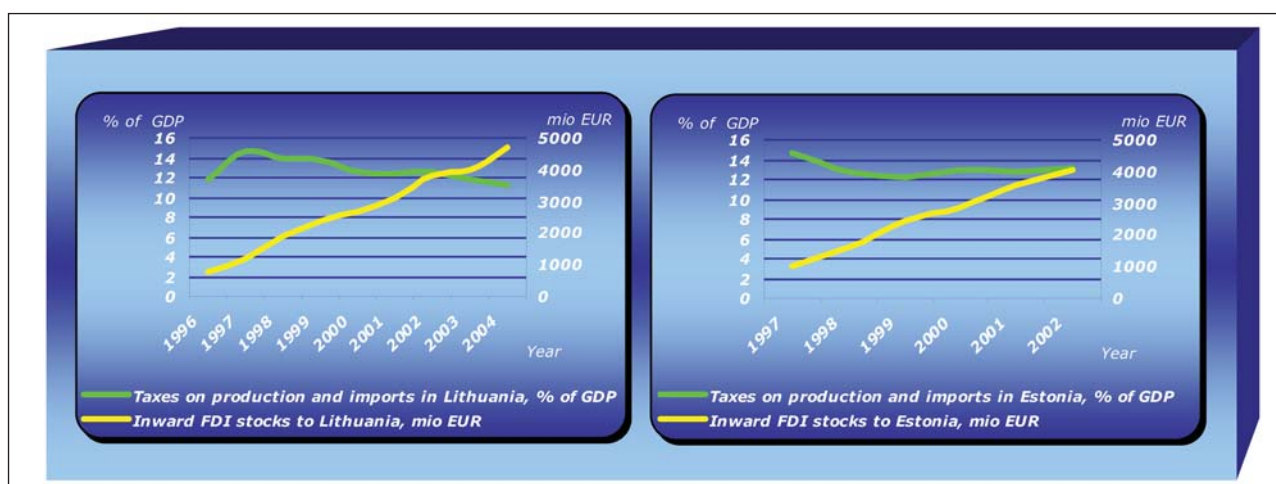
Correlation coefficients are not very significant for both countries. Moreover, they show a negative correlation between variables. In order to determine the significance of each variable used in the analysis, Student's *t*-distribution is taken into consideration and also absolute values for each time series are calculated. Probability associated with the two-tailed Student's *t*-distribution here is 0,05 and number of degrees of freedom to characterize the distribution are 7 and 4 for Lithuania and Estonia respectively. The results show that for Lithuanian inward FDI stocks, taxes on production and imports as a factor is not a significant determinant because *t*-observed is smaller than *t*-statistics. For Estonian inward FDI stocks taxes on production and imports seems to be not significant as well because *t*-observed is much smaller than *t*-statistics.

Consequently, the 5<sup>th</sup> hypothesis had to be rejected for both Lithuania and Estonia, if we made a decision only from the obtained results. Correlation analysis showed not enough significant negative relationship between variables for both countries. The reason for that could be too small sample of observations. In any case, the relationship is negative, and it reflects a tendency which, in turn, proves the 5<sup>th</sup> hypothesis: lower taxes attract more inward FDI to the host economy, other things being equal.

To conclude the tax burden analysis in respect of inward FDI, it is important to note, that lower taxes are not

**Table 5.** Correlation coefficient, *t* value and *t* statistics for taxes on production and imports to inward FDI stocks for Lithuania and Estonia

Country	r	t-observed	t-statistics
Taxes on production and imports to FDI inward stocks			
Lithuania	-0,60	2,01	2,36
Estonia	-0,50	1,14	2,78



**Fig 5.** Dynamics of inward FDI stocks and taxes on production and imports

Sources: Lithuanian Department of Statistics, EUROSTAT



always the significant driving force for foreign investors. Some of them find more important to improve the infrastructure and business conditions instead of charging low taxes.

## 6. Economic interpretation of the obtained results

Preceding discussion has shown that there exist sophisticated relations between certain macroeconomic variables and inward foreign direct investment. In general, the study aimed to analyze, whether the same factors can differently affect inward FDI in neighboring countries in the same region. Neighboring countries analyzed are Lithuania and Estonia located in the Baltic region. Outlined findings and suggestions stemming from the performed analysis are as follows:

1. Considering *foreign trade* as one of the FDI causing factors, academic literature suggests that exports and imports reflect the openness of the economy and the impact of these variables on inward FDI is positive. The task of the analysis was to test this hypothesis for Lithuania and Estonia.
  - Empirical results confirm this theoretical finding for Lithuanian case, but deny it for Estonia. The main impediment for Estonian case is a lack of time series data for comparative study.
  - It appeared that trade liberalization policy in Lithuania seems to be encouraging inward FDI; therefore, in order to sustain growth, government has to follow the set course of action.
2. Regarding *market size* expressed in term of Gross Domestic Product, literature characterizes GDP level to be reflecting the purchasing power of the country and representing its market capability, consequently, having a positive impact on the FDI inflows. The study aimed to find out, whether it is true for Lithuanian and Estonian cases. Consequently, obtained results appeared to be fully consistent with theory:
  - Growing GDP level has a positive effect on attracting FDI to both Lithuania and Estonia.
  - On the other hand, inward FDI boosts country's GDP and accounts for the foreign debt's share in the GDP structure.
  - Consequently, the question arises, either GDP growth causes FDI inflows, or FDI determines GDP growth. However, it is proved that these two variables are strongly correlated with each other and a country's wealth, in any case, is a significant factor in terms of attracting investment.
3. *Labor force* analysis in respect of inward FDI was performed comparably to the scientific articles and provoked the following inferences:
  - Academic literature suggests that *wage rate*

increases the cost of production and has a negative impact on FDI. Surprisingly, empirical study contradicts theory and submits opposite results.

- Analysis shows that wage rate increases along with FDI inflows both in Lithuania and Estonia, although the opposite result was expected to take place. Possible reason is that increasing wage rate reflects the growth in economy, which, it is proved, has a positive impact on FDI.
  - Scientific articles conclude that increase in *labor productivity* improves the production capability of the firms. Consequently, productivity of labor force should have a positive impact on the FDI inflows. The empirical study supports theoretical proposition for both analyzed countries.
  - Also, analysis discovered that Estonia distinguishes by higher labor productivity than Lithuania; therefore, it owns better labor potential and, at that point, has the advantage over Lithuania.
  - Consequently, labor productivity became one of the indicators reflecting human resource competitiveness, which, in turn, has to be constantly increased and sustained in order to foster competitive advantage in the international market.
  - Keeping in mind strong correlation between labor productivity and inward FDI, the converse conclusion could be drawn, namely, that FDI can be an important source for productivity growth and also encourage transformation process in transition countries.
4. Academic literature states that lower *tax rates* attract foreign investors into the host country. Therefore lower taxes are expected to have a positive impact on inward FDI. In order to test the above hypothesis, taxes on production and imports were correlated with inward FDI and obtained results induced the following concluding remarks:
    - There is no straightforward answer to the question. Although the study does not provide empirical evidence considering taxes on production and imports a significant FDI driving factor, analysis discovers weak negative correlation between variables.
    - Subsequently this shows a very clear tendency for both Lithuania and Estonia: lower taxes tend to attract more inward FDI, other things being equal.
    - Also, some scientific articles contradict the above, stating that lower taxes are not always a significant FDI driving force; they find improved infrastructure and business conditions being much more significant.

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**FAKTORINĖ TIESIOGINIŲ INVESTICIJŲ LIETUVOJE ANALIZĖ****M. Degutis, M. Tvaronavičienė****Santrauka**

Straipsnyje nagrinėjamos tiesioginių užsienio investicijų (TUI) Lietuvoje ir Estijoje tendencijos bei makroekonominiai veiksniai, lemiantys TUI judėjimą iš kapitalą eksportuojančių šalių. Autoriai analizuoja ekonomines sąlygas, kuriomis TUI galėtų paveikti eksportą ir importą. Tiriamos prielaidos apie tarpusavio santykį tarp TUI ir šalių ekonominio augimo, tarp darbo jėgos kainos ir TUI, tarp mokesčių naštos ir TUI. Taikydami matematinius statistinius metodus, autoriai kiekybiškai įvertina tiriamus ryšius, ekonomiškai interpretuoja gautus rezultatus.

**Reikšminiai žodžiai:** tiesioginės užsienio investicijos, ekonominio augimo veiksniai.

**Mantas DEGUTIS.** Master student at Vilnius Gediminas Technical University, Business Management Faculty. Research interests: foreign direct investments.

**Manuela TVARONAVIČIENĖ.** PhD, works as Associate Professor at Vilnius Gediminas Technical University, Department of Economics and Management of Enterprises. Her research interests involve tax system's reforms in transition economies, investigation of legal tools of conditioning of business environment and factors stimulating investment processes in transition countries.