

FOREIGN DIRECT REAL ESTATE INVESTMENTS IN LATVIA IN THE CONTEXT OF THE DEVELOPMENT OF THE NATIONAL ECONOMY

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Abstract. Real estate investing has a major role in the development of each country. Nowadays, in the context of increasing globalization level, one of the most important objects of the analysis is the foreign direct investment in real estate. The investment multiplier effect in the real estate market is also very important, as the real estate market and construction industry investments are approaching also other sectors, which is in turn increasing the gross domestic product. The aim of the study is to analyze foreign real estate investments in Latvia, by examining a number of scientific and practical aspects associated with this matter. The statistical data analysis, comparative and logically constructive methods have been used in the study. The importance of this matter and the direction of future researches have been defined. The study also provides recommendations for branch regulation planning.

Key words: real estate investments, FDI, real estate market, construction development, fiscal policy.

JEL code: E22; F21; F62; R30

Introduction

Real estate investments are one of the most popular types of investments. The total impact of the foreign direct investments on the overall development of the country has been analysed in the study. *The aim of the research* is to analyze foreign direct real estate investment development tendencies in Latvia, by examining a number of scientific and practical aspects associated with this issue as well as by defining their impact on the national economy. The object of the research is the real estate market of Latvia. The statistical data analysis, comparative and logically constructive methods have been used in the study. The importance of this matter and the direction of future researches have been defined as well. The study also provides recommendations for branch regulation. In the course of the study, it has been also observed that the increase in the price level of the real estate objects is also related to the increase in the foreign real estate direct investing. The importance of the study is also determined by the fact that the study of investment is of great importance for the understanding of the business cycles and economic activity (House, 2014).

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1. Theoretical Aspect Overview

It should be noted that the economies of several countries are interrelated, and the increase in the foreign direct investing can be observed in many countries and regions. The interrelation of investment flows and real estate market is being determined by the following major aspects (Vanags, 2007):

- **investment relationship with the real estate development process;**
- **dominant role of the real estate in business and its expansion;**
- **crucial role of land in agricultural production and construction, business expansion;**
- **significance of investments in the construction industry;**
- **impact of the state economic policy on the investment flow and real estate markets as well as other aspects.**

Fiscal policy of government plays a great role in regulating investment inflows and outflows. By analysing Hungary, Latvia, Lithuania, Poland and Romania, for the period 2000-2010, the strong support has been defined for the conjecture, which states fiscal policies are determinants for FDI and fiscal competition between governments for FDI is a business environment, which is determined primarily by fiscal policy (Göndör and Nistor, 2012). Measuring the effects of discretionary fiscal policy is both difficult and controversial (Bouakez, Chihi, and Normandin, 2014). At the same time a more countercyclical fiscal policy significantly enhances output growth in more financially constrained industries, in which counterparts are more dependent on external finance or display lower asset tangibility (Aghion, Hémous, and Enisse Kharroubi, 2014).

Investment volumes in the country also affect the interest rates and capitalization rates. Changes in monetary policy affect the conditional mean of the short-term interest rate which in turn affects macroeconomic variables such as output, employment, and inflation (Gust and López-Salido, 2014). A variety of internal and external factors affects investment decision-making, and one of the most important are provisional results of calculations before making a decision. The choice of capitalization rate is important procedure - a slight change, increasing or decreasing, of the capitalization rate corresponds to significant inverse variations in the estimations (Manganelli, Morano, and Tajani, 2014). Real estate needs effective management in order to generate income in a greater degree than other assets and at the same time (Asaul, 2004):

- **real estate is a fairly complicated product as an investment object for most investors;**
- **it can be the object of investment, allowing to derive more profit for investors with sufficient knowledge in the field of real estate management.**

The study of the foreign direct investments should involve also the consideration that several phenomena have both positive and negative effects. In practice, different influences on real estate market and construction sector are observed – at macro level (country and industry), at mezzo level (projects and enterprises) and at micro level - project and organization level (Tamosaitiene, Zavadskas, and Turskis, 2013). Both positive and negative

effects of FDI are obvious. FDI may be considered as a catalyst to business creation, especially in combination with governance strength, by attracting desirable types of FDI (Herrera-Echeverri, Haar, and Estevez-Breton, 2014). The estimated returns of FDI inflow in a host country are technology diffusion, capital accumulation, intellectual property transfer, know-how, acquisition of managerial experience and others (Temiz and Gökmen, 2014). It is important to mention that FDI can have an impact on the economic growth also by affecting technology transfer, mostly when an absorption capability of advanced technologies exists in the national economy (Borensztein, Gregorio, and Lee, 1998). It has also been researched (Aurangze and Borsa, 2014) that the countries with higher levels of FDI inflows have higher factor-productivity in the export sector in comparison with the countries with low FDI inflows and export-oriented policies play an important role during the development process.

At the same time, it is suspected that FDIRE may have a side effect of overheating the real estate market (Hui and Chan, 2014). There are different versions about causes of real estate market overheat. McDonald and Stokes (2013) divide real estate market bubbles reasons to four parts – unsound lending practices created by financial sector, complex mortgage-backed **securities, the shadow banking system that relied on high degrees of financial leverage and** short-term borrowing as well as other reasons. Also if globalization actually increases within and between countries, as diverse range of exports, inequality above moderate levels may cut world aggregate demand and thereby world economic growth by rising world inequality and slower world growth (Wade, 2004), so international contagion risks exists among real estate markets requires international cooperation among financial regulators (Hatemi-J, Roca, and Al-Shayeb, 2014). As FDI has the potential to provide both positive and negative macroeconomic effects for the recipient countries, it is extremely difficult theoretically to predict the respective degree of these countervailing effects, and therefore the empirical researches have to be made (Iwasaki and Tokunaga, 2014).

Long-term investor experience is better to be captured by compounding short-term returns in order to obtain long-term buy-and-hold returns (Fama, 1998). The nature of investor protection and regulation of financial markets in each country is deeply rooted in the legal structure of each country and in the origins of its laws (Porta, Lopez-de-Silanes, Shleifer, and Vishny, 2000). In addition, there are fundamental differences between small and large enterprises, such as the difference between the size of company and corporate finance practices - small enterprises are less sophisticated when it comes to evaluating risky projects than large enterprises (Graham and Harvey, 2001). The advent of the real estate securitization mechanism provides increased liquidity for traditional real estate investment (Lee, Chien, and Lin, 2012). In investment flow analysis it is necessary also to analyse the factors affecting the demand. The non-price factors affecting the demand are the following (Vanags, 2010):

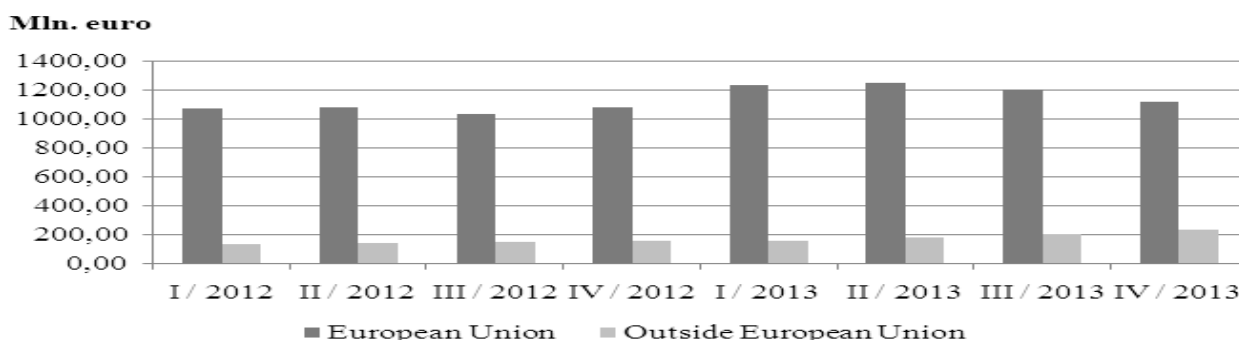
- a) increase or decrease in the income of the participants forming the household and other market demands;
- b) state monetary and fiscal policy;

- c) changes in state demographic situation;
- d) state regional policy;
- e) location of saleable immovable product;
- f) future expectations of potential buyers;
- g) attitude of potential buyers to the environment and other factors.

Demand analysis has a great role in real estate valuation as well. A link between real estate valuation and the current account deficit follows from fact that the growing deficit of the current account is a signal of a growing gap between the spending of domestic residents and their output. This was observed in both periods before and after the crisis of 2008-09 (Aizenman and Jinjarak, 2014). Economy in general has range of tasks, which should be solved, and it is a complicated process. The compromise should be found and the priority targets should be selected. Therefore, the economic policy regulation should also take into account the needs of the society, which would at the same time contribute to the development of the total construction industry and the real estate market.

2. Practical Research Part

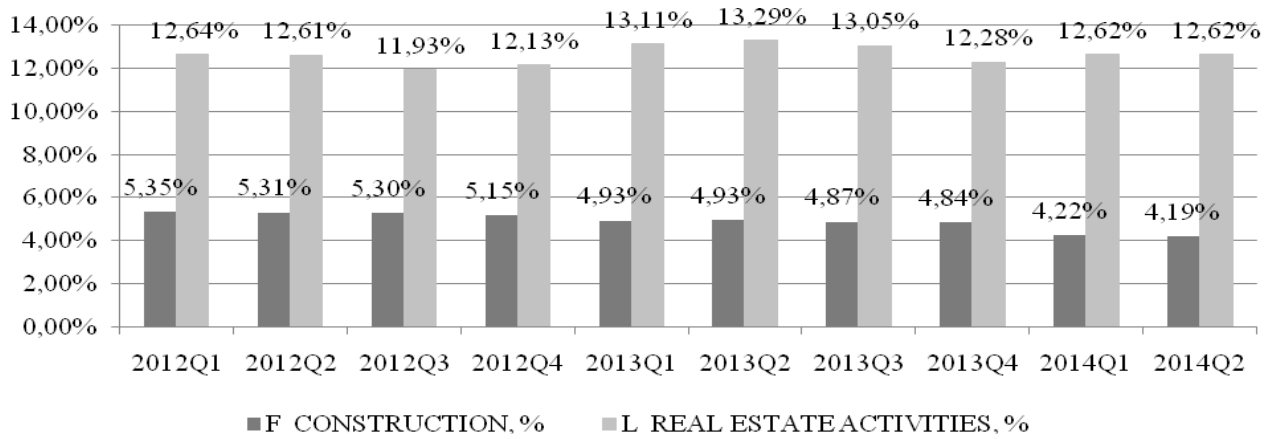
By analyzing FDI in Latvia, it can be concluded that the amount of direct investment of the EU countries substantially exceeds the amount of direct investment of any other group of countries, and this predominance is presented in Figure 1 and can be observed in 2012 and 2013.



Source: author's construction based on Eurostat Statistical Data

Fig.1. **FDI data in Latvia by countries**

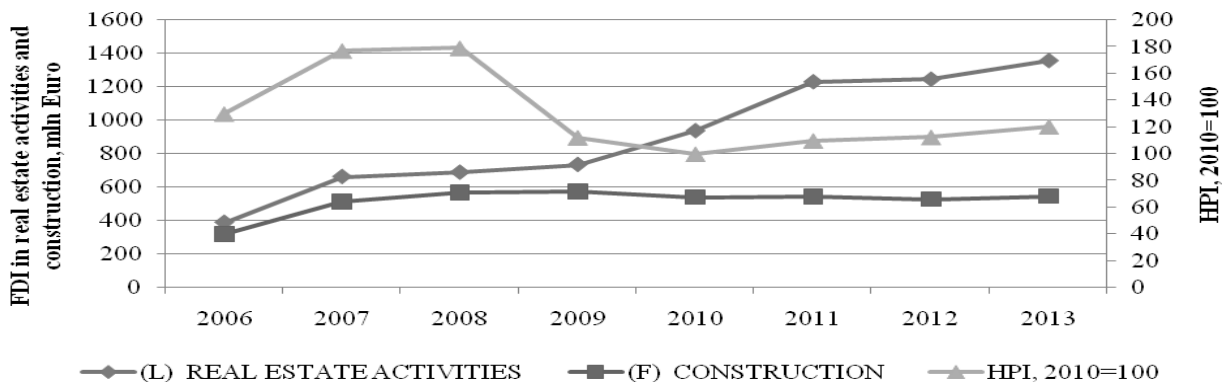
By analyzing results of the construction industry and real estate market, which are presented in Figure 2, it can be concluded that over the period from the second quarter of 2012 to the second quarter of 2014, the ratio of the real estate transactions in the total foreign investments exceeds the foreign investments in the construction industry by approximately two times, and in the analysed period they ranged from 11.93% to 13.29% of the total foreign investments in the real estate sectors, so the ratio of the foreign real estate investing over the analysis period has kept its positions. Since the development of the construction industry creates new jobs, it is advisable to take measures to increase the level of construction investments in order to develop this industry and the economy in general.



Source: author's construction based on Latvian Bank Statistical Data

Fig.2. The share of construction industry and real estate operations in GDP of Latvia, %

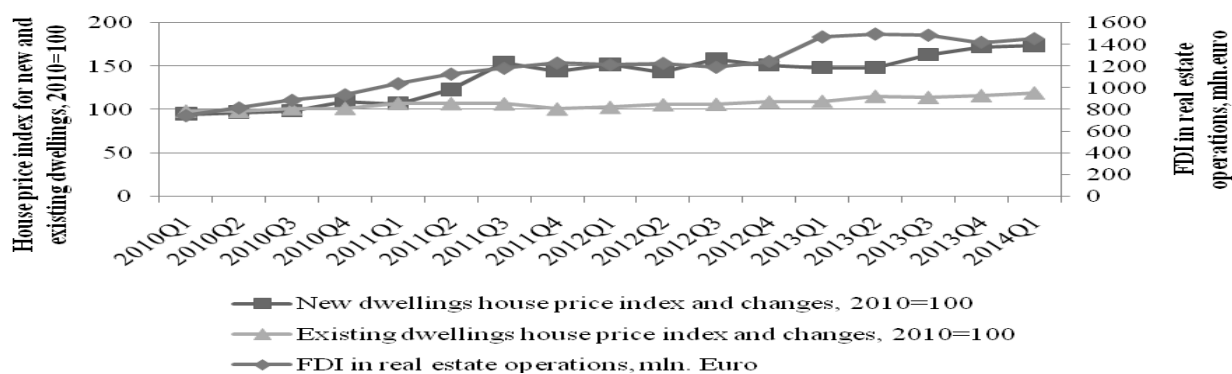
Figure 3 presents the FDI data by kind of activity and house price index in Latvia over the period from 2006 to 2013. By analyzing information, it can be concluded that FDI in real estate development dynamics in Latvia has substantially avoided the crisis in 2009, and after the amendments to the Immigration Law, the real estate investing in Latvia has only increased. Figure 3 presents that the house price index and FDI in real estate had similar development trends in Latvia starting from 2010.



Source: author's construction based on Latvian Bank and Eurostat Statistical Data

Fig.3. FDI data by kind of activity and house price index in Latvia

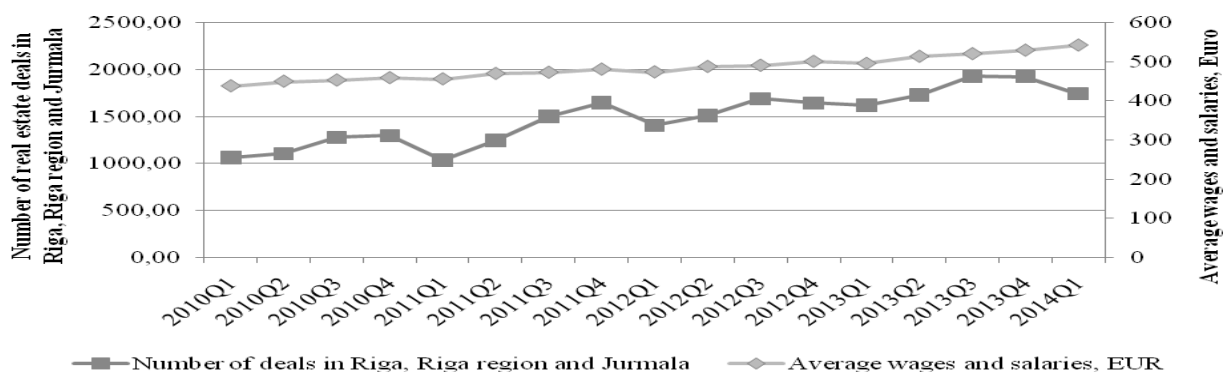
From the first quarter of 2010 to the first quarter of 2014 the foreign direct investments grew by 95.41% - from EUR 744.26 million to EUR 1454.34 million (see Figure 4). The purchasing power does not grow so rapidly as the real estate prices, which are influenced by the foreign investing. From the first quarter of 2010 to the first quarter of 2014 the average wages in Latvia have grown by 23.97%, the house price index of the new dwellings grew by 78.99% and the house price index of the existing dwellings grew by 20.74%. The largest number of transactions has long been observed in Riga, Riga region and Jurmala (Geipele et al., 2013). The State Land service data (2013) shows that these are the most demanded areas in Latvia for foreign investors.



Source: author's construction based on Latvian Bank and Central Statistical Bureau of Latvia Statistical Data

Fig.4. FDI in real estate operations and house price index for new and existing dwellings in Latvia

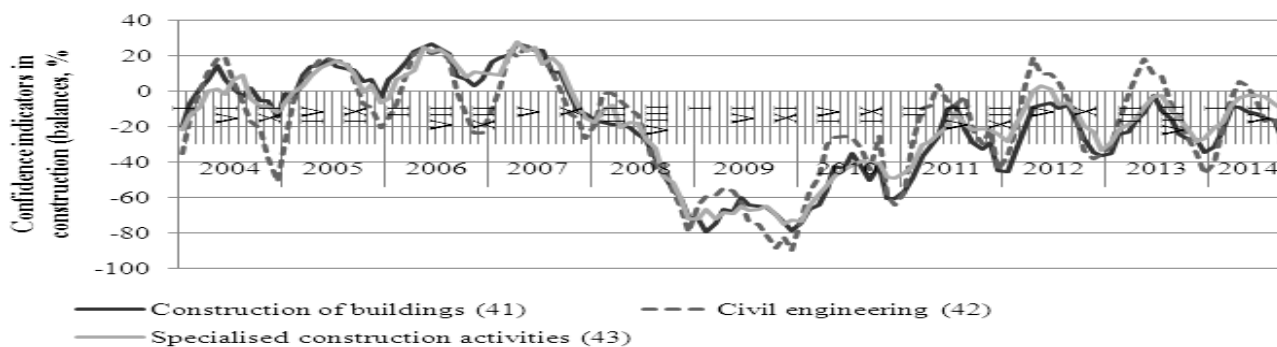
In the context of price level changes, the existing dwellings are less affected, because the foreign investors prefer new dwellings. The average wages in Latvia are also not increasing so rapidly as the number of real estate purchases (see Figure 5).



Source: author's construction based on Central Statistical Bureau of Latvia and a State Unified Computerised Land Register Statistical Data

Fig.5. Real estate deals and average salary in Latvia a State Unified Computerised Land Register

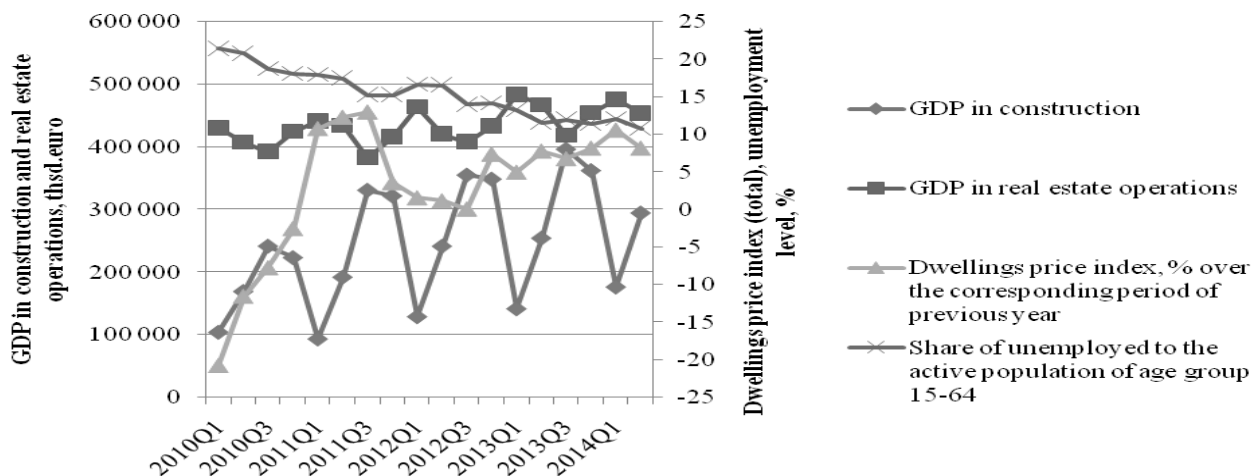
Since 2009 all confidence indexes in construction of buildings, civil engineering and specialized construction activities have been improved, but in 2014 confidence index in civil engineering has reduced in comparison with the previous year. Confidence indicators in construction in Latvia are presented in Figure 6.



Source: author's construction based on Central Statistical Bureau of Latvia

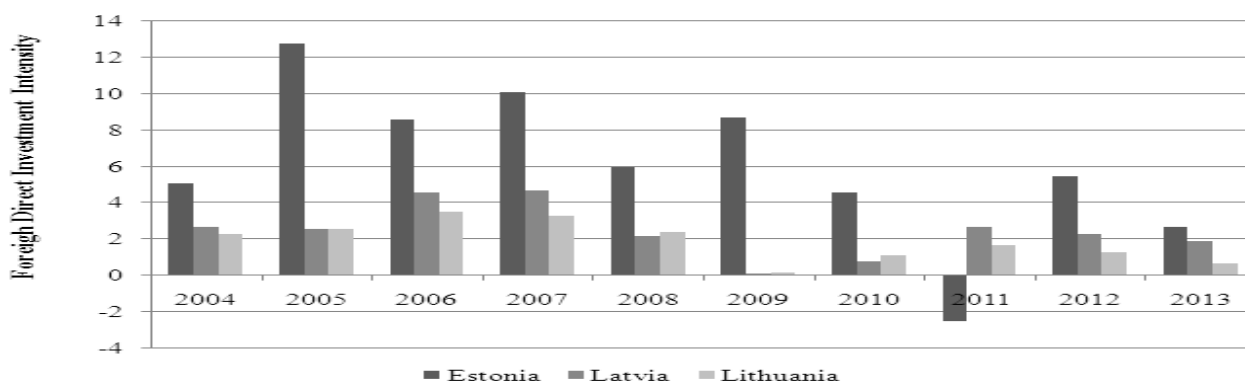
Fig.6. Confidence indicator in construction in Latvia (balance, %)

GDP indicators in construction and real estate operations, changes of dwellings price index and unemployment level are presented in Figure 7. From the first quarter of 2010, GDP indicators in construction and real estate operations as well as dwellings price index have been improved, and the unemployment level has been reduced, which was the positive development tendency of national economy.



Source: author's construction based on Central Statistical Bureau of Latvia
Fig.7. Real estate market and economic indicators in Latvia

GDP in real estate operations also has a cyclical development tendency. Market integration indicator - Foreign Direct Investment (FDI) intensity index in the Baltic States - varies, and is lower in post-crisis period than in 2005-2007. Market integration indicator - FDI intensity in the Baltic States over the period from 2004 to 2013 is presented in Figure 8.



Source: author's construction based on Eurostat Statistical Data
Fig.8. Market integration - Foreign Direct Investment intensity - Average value of inward and outward Foreign Direct Investment flows divided by GDP, multiplied by 100

FDI intensity indicator is one of the market integration indicators, which also presents a globalization level dynamics and Estonia has a leading position and highest FDI intensity level among all Baltic countries.

Conclusions

1. In the current study, the positive and negative FDI effects on the national economy have been reviewed as well as the practical research has been carried out, mainly focusing on the situation in Latvia. The real estate market can solve a number of socio-economic problems, so its importance is growing in the course of time.
2. Taking into account the fact that the investments in real estate market and construction industry are of great importance, they also affecting a national economy development. During the research period, the higher FDI volumes have been invested in real estate operations. In consequence of the development of the construction industry, the new working places are being created, so it is advisable to take measures in order to increase the investments in the construction industry and to develop this industry and the economy in general.
3. Fiscal policy should take into account a number of potential problems, analyze them from different perspectives as well as review the specifics of the investment decision making. Business representatives should regularly follow the development trends of the macroeconomic indicators, including the consumer confidence index as well as the confidence indexes in the industries, in which they are operating. In the further researches, the fiscal policy regulation shall be analysed in more details and more countries shall be involved.

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