

The Estonian Economy

Neighbouring countries' impact on the Estonian economy is waning

- ▶ Finland, Sweden, Latvia, and Russia – Estonian closest neighbours – contribute about one-fifth to Estonian GDP through exports.
- ▶ The share of the four neighbouring countries' tourists' expenditure is about 60% of the expenditure of all tourists.
- ▶ Finland and Sweden have had a considerable impact on Estonian economic development through foreign direct investments (FDI) – roughly half of total inward FDI stock has come from these countries (25% from Sweden and 23% from Finland).
- ▶ The share of labour income from Finland, Sweden, Latvia, and Russia contributes about 60% of total labour income derived abroad, while 44% of labour income from abroad comes exclusively from Finland. Estonian residents' labour income from abroad is around 3% of total compensation of employees paid in Estonia.
- ▶ We expect that the economic impact of Estonia's closest neighbours will decrease in the next few years.

Estonia, as a small and very open economy, is largely affected by the external environment. Especially, Estonia depends to a great extent on its neighbouring countries – Finland, Sweden, Latvia, and Russia. However, the impact of Russia and Latvia is considerably smaller than that of Finland and Sweden. Although a comprehensive analysis of the impact of neighbouring countries on the Estonian economy should contain a considerably wider range of indicators, we have narrowed our work primarily to the overview of trade, tourists' expenditure, FDI, income on foreign portfolio assets, and labour income. The impact on the Estonian economy comes mainly from trade, FDI, and tourism. A relatively large number of Estonian residents work abroad, especially in Finland. However, the share of labour income from abroad is quite small compared to total compensation of employees paid in Estonia.

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About one-fifth of Estonian GDP comes from exports to its closest neighbours – Finland, Sweden, Latvia, and Russia

In 2018, Estonian enterprises exported to its neighbouring countries (Finland, Sweden, Latvia, and Russia) goods and services in total amount of EUR 8 billion, which is about 40% of total exports. Five years ago, this share was even larger – about half of total exports went to these neighbouring countries. Considering that the share of value added in exports created in Estonia is about 67%,¹ these countries have contributed about one-fifth to the GDP through exports.

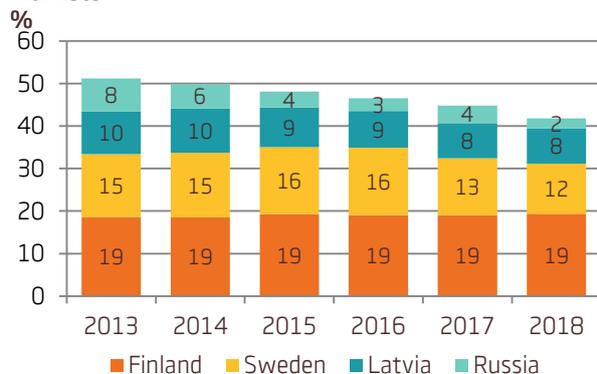
¹ Swedbank Macro Research estimate of domestic value added in gross exports based on OECD data.

Finland is the largest exporting partner, with a share of 19% in total exports, and the contribution to GDP from exports to Finland is largest among export partners' – around one-tenth. Finland is also important, as exports of goods to Estonia's northern neighbour is the most broad based among the major export partners. Finland and Sweden are important markets to the wood, furniture, and electronics industries and to electrical equipment producers. In addition, Estonia exports to Finland products of iron and steel, and machinery and equipment produced in Estonia. About 90% of electricity and 10% of oil products, including shale oil products, are exported from Estonia to Latvia. Russia's share in Estonian exports is smaller (in 2018, 2.4% of total exports), but machinery and equipment and some chemical products should also be noted (Table 1 in the Annex).

Last year, total export of goods and services to neighbouring countries (Finland, Sweden, Latvia, and Russia) remained roughly flat² in nominal terms compared with the year earlier. While exports to Latvia and Finland increased from the year before, they fell to Sweden and Russia. At the same time, total export volume growth was 4.3%;³ however, faltering global demand and political and economic uncertainty will hamper Estonian enterprises' export growth opportunities. Behind the slowdown of exports to Sweden is a decrease in exports of mobile equipment, which is the main export article to Sweden (14% of total exports of goods to Sweden in 2018). Last year, the share of exports of mobile equipment in total exports of goods to Sweden decreased by a factor of two from the previous year and was three times lower than in 2015. On the other hand, the impact of the decrease in exports of mobile equipment to GDP is proportionally smaller, as its share of value added in turnover is very modest. The largest decrease in exports to Russia, meanwhile, was in machinery and equipment, and chemical products. It should be noted that in five years exports share to Russia has declined considerably – from 8% to 2%, mainly due to the decrease in chemical products.

Changes in exports and imports affect the transportation sector. In addition to the foreign trade recorded in exports and imports in national accounts and balance of payments, warehousing and support activities for transportation are affected by transit, as well. Most of the goods transiting through Estonia are transported through Estonian main ports⁴ (about 70%), but the share of goods transported through main ports to and from neighbouring countries' is only around 40%. About 20% of transit goods are transported by railway. Most of the transit goods passing through Estonia by railway come from Russia (about 80%). In recent years, the total volume of transit goods transported by railway has decreased considerably, but last year showed strong growth again. However, it is difficult to foresee volume growth in the near future.

Export shares to our neighboring countries' markets



Source: Bank of Estonia

The share of tourists' expenditure from neighboring countries



Source: Bank of Estonia

² According to balance of payments.

³ In real terms according to Statistics Estonia.

⁴ Kunda, Miiduranna, Pärnu, Sillamäe, Tallinn, Vene-Balti ports

Finnish tourists' share in total expenditure of tourists is about 40%

Last year, total expenditure made by foreign tourists visiting Estonia was EUR 1.5 billion (5.9 % of GDP). The share of expenditure of tourists from the four neighbouring countries was 57% in the expenditure of all tourists (3.3% of GDP), or EUR 0.9 billion. Finnish tourists' expenditure is the highest, accounting for 37% in the expenditure of all tourists (2.2% of GDP). However, the share of expenditure of tourists from the neighbouring countries was much larger five years ago – about 70% – and has been continuously decreasing. The impact of neighbouring countries' tourists' expenditure on the Estonian economy has also decreased in the last five years – from 4.6% to 3.3% of GDP (Graph 1 in the Annex).

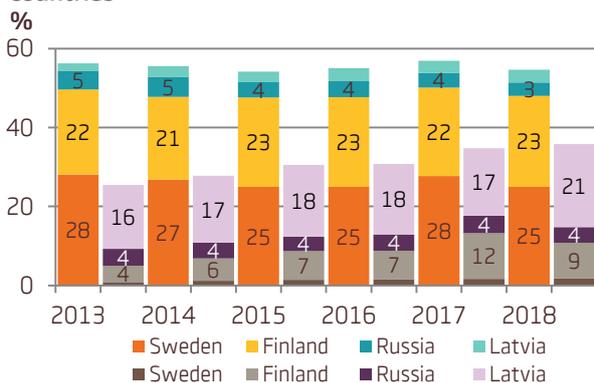
In 2018, there were about 6 million tourist visits to Estonia, of which the share of visits from the four neighbouring countries was 63% of the total. Last year, even though the total days of Finnish tourists' visits to Estonia decreased considerably, Finnish tourists still spent 2% more than in the previous year. However, the impact of the price growth should also be considered – consumption adjusted for inflation has slightly decreased. The total number of days of Latvian, Russian and Swedish tourists' visits increased in 2018. However, the share of Russian tourists' expenditure in total expenditure decreased. The expenditure of neighbouring countries' tourists visiting Estonia rose slightly, but, as mentioned above, this growth of expenditure was supported by inflation.

Finland and Sweden have had a large impact on the Estonian economy through FDI

The share of the four neighbouring countries' FDI in total stock of inward FDI to Estonia is more than one-half (55% last year), or EUR 11.6 billion. Although total investments from these countries have increased in the long run, the ratio to total FDI has decreased (Graph 2 in the Annex). While the share of FDI from Latvia and Russia was about 3% last year, the largest share of FDI comes from Sweden (25%) and Finland (23%), which together account for almost half of all FDI. However, the share of inward FDI stock from Sweden has fallen substantially. Fifteen years ago, the share of FDI from Sweden was more than 40%, and from Finland more than 25%. Thus, Estonia's northern neighbours have had a major impact on the economy. In addition to the contribution to goods and services production in Estonia, these countries have also "exported" knowledge of corporate management and created new jobs.

The four neighbouring countries have also offered an opportunity to Estonian companies to expand their businesses. Outward FDI made by Estonian companies to these countries have increased and currently accounts for more than one-third of total outward FDI. The largest investments by Estonian companies are made to Latvia and to another Baltic country, Lithuania, each accounting for about one-fifth of all Estonian enterprises' FDI. Although investments to Latvia have increased, the share in total outward FDI has decreased after the last economic crisis.

The share of inward (left bar) and outward (right bar) FDI stock of neighboring countries



Source: Bank of Estonia

The share of labour income from neighboring countries



Source: Bank of Estonia

Please see important disclosures at the end of this document

Outward portfolio investments are higher than inward portfolio investments to neighbouring countries

In 2018, the stock of inward foreign portfolio investments was EUR 2.4 billion and outward foreign portfolio investments was EUR 12.8 billion. Last year, the net outflow from foreign portfolio investments continued and was EUR 700 million. The net outflow from portfolio investments was supported by central bank investments in debt securities as part of the asset purchase programme of the European central banks and by the investments of pension funds. In 2018, portfolio investments from the four neighbouring countries were EUR 720 million, while portfolio investments to these countries were EUR 1.4 billion. However, Russia's share is very small. Outward portfolio investments outpace inward portfolio investments to the neighbouring countries mainly due to the investments of pension funds. Last year, the net inflow of portfolio investments from neighbouring countries was EUR 6 million, although, in the previous years, there was a net outflow.

Labour income derived from abroad has decreased only in Finland

The search for a higher salary and better living standard has driven Estonian residents to work abroad, especially in the labour markets of its northern neighbours. The share of labour income from the four neighbouring countries is about 60% of total labour income derived from abroad. Last year, Estonian residents earned EUR 335 million of labour income from abroad; the largest share of labour income (44%) came from Finland, followed by Norway (12%) and Sweden (8%). However, in recent years labour income from Finland has decreased. The reason for this decline is the decrease in the number of Estonian residents working in Finland, especially in the construction sector. While in the last five years, labour income from Finland has decreased, it has increased in Sweden, Latvia, and Russia and remained on the same level in Norway. However, labour income of Estonian residents from abroad is small compared with the compensation of employees received in Estonia – only about 3%, and the share of Estonian residents working abroad is also only about 3% of employed residents in Estonia. However, it should be considered that this is only the official number, and in reality the number of employed persons abroad and in Estonia could be higher.

The impact of Estonian neighbouring countries is expected to decrease

We expect that foreign demand, including the demand from Estonia's closest neighbours, will weaken in the next few years. Therefore, Estonian exports to its neighbouring countries will most likely contribute less to economic growth. In addition, rising costs, lowering potential output growth, and the shortage of qualified labour could have a negative impact on inward FDI flows to Estonia. Although, Estonia is ranked relatively highly globally on the ease of doing business index (16th out of 190 countries), it should improve this position even more, as other countries in the Baltic-Nordic region are highly ranked as well. Estonia's general economic competitiveness and innovation level are better than its Baltic neighbours, but it remains far behind Sweden and Finland. In addition, the demand of foreign employees in the Nordic countries is expected to decrease, as well, due to the slower economic growth, especially in the construction sector. Labour income from the Nordic countries and its share in total labour income are expected to fall gradually as the gap between wage levels with Estonia is narrowing. The tourism sector needs more and better-organised conference facilities in order to attract more tourists for business purposes. Currently, the share of foreign tourists participating in conferences is only 3% of the total. To summarise, we expect that the contribution of Estonia's closest neighbours to its economy will decrease in the next few years.

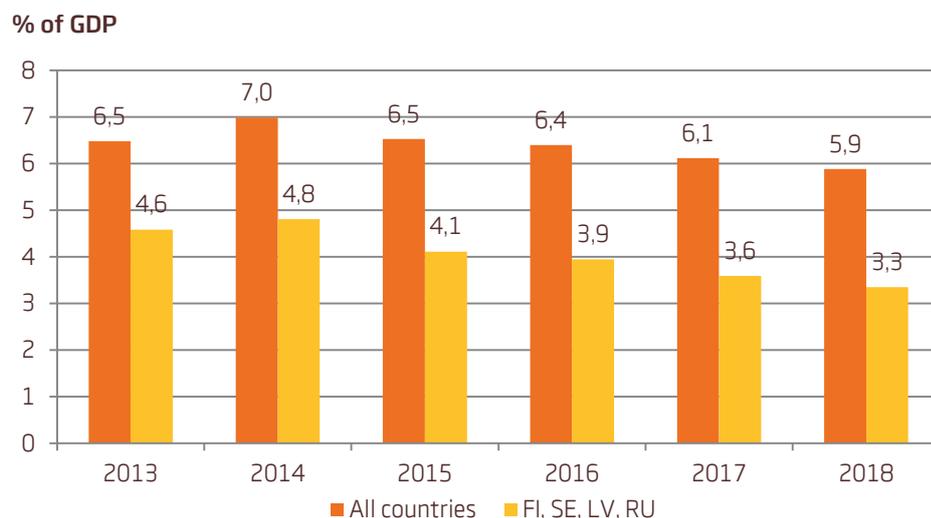
Annex

Table 1. Main export of goods articles to Finland, Sweden, Latvia, and Russia in 2018

Finland	Sweden	Latvia	Russia
Electrical machinery and equipment	Electrical machinery and equipment	Mineral fuels, oils	Machinery and equipment
Furniture	Wood, articles of wood	Wood, articles of wood	Tanning and dyeing extracts
Articles of iron or steel	Furniture	Dairy products	Electrical machinery and equipment
Wood, articles of wood	Articles of iron or steel	Beverages, spirits	Plastics
Machinery and equipment	Parts of the motor vehicles; trailers and parts thereof	Plastics	Articles of apparel and clothing

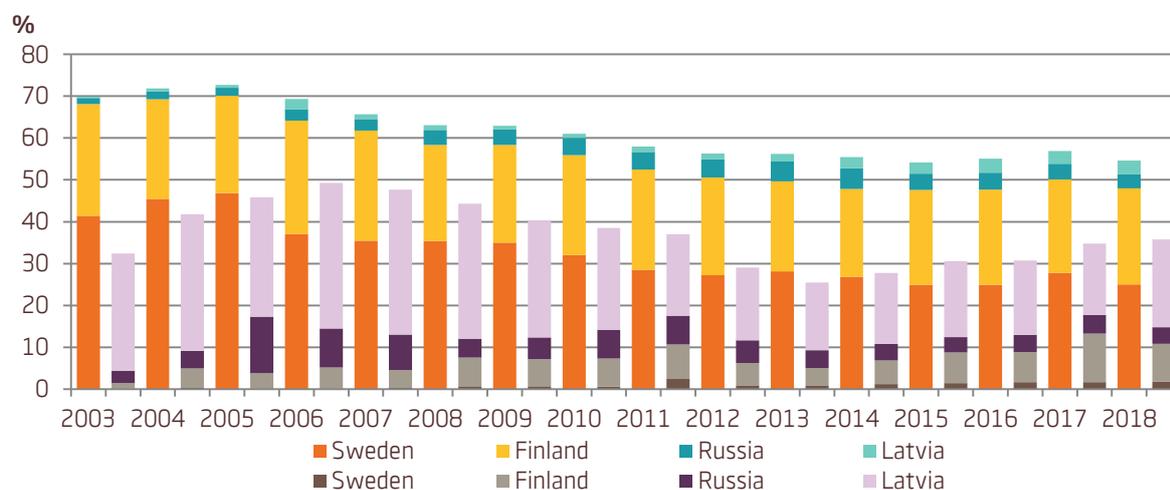
Source: Statistics Estonia.

Graph 1. The share of tourists' expenditure in GDP



Source: Bank of Estonia

Graph 2. The share of neighbouring countries' in inward (left bar) and outward (right bar) FDI



Source: Bank of Estonia

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