

Estonian Economy

Increasing Estonian exports' market share in Finland will be more challenging

- ◇ Estonia's exports to Finland are the most diversified among the largest trade partners
- ◇ Exported goods from Estonia have gained market share on the Finnish market
- ◇ Estonia is losing its price competitiveness against Finland

Finland is Estonia's largest export partner. Among the 10 largest trade partners, Estonia's exports of goods¹ to Finland are the most diversified. The recovery in import demand from Finland has given more export opportunities, and the number of enterprises exporting goods to Finland has increased during the last two years. Since 2015, the share of the Finnish market in total exports of goods from Estonia has increased; however, it is still lower than the level before 2011. Exported goods from Estonia lost some market share in Finland in 2017, but the longer time series show a more positive picture: Estonia has gradually gained market share in Finland since 2008. Despite the expected moderate slowdown in 2018-2019 of Finnish economic growth, its import demand should be relatively strong and Finland should remain among the largest contributors in foreign demand for Estonian exports, at least in the near future. At the same time, we have to consider that, because Finland has been able to limit the growth of its unit labour costs in recent years, Estonia is losing its price competitiveness against it. Despite Estonian prices of goods have been relatively flat compared to the Finnish average in the last 10 years (primarily due to the faster price growth of capital goods in Finland), Estonian general price level of the total economy has converged closer to the Finnish prices. Thus, investing more in product development and productive capital and improving corporate management, work organisation, and supply chains are needed for Estonia to halt its decline in competitiveness on the Finnish market.

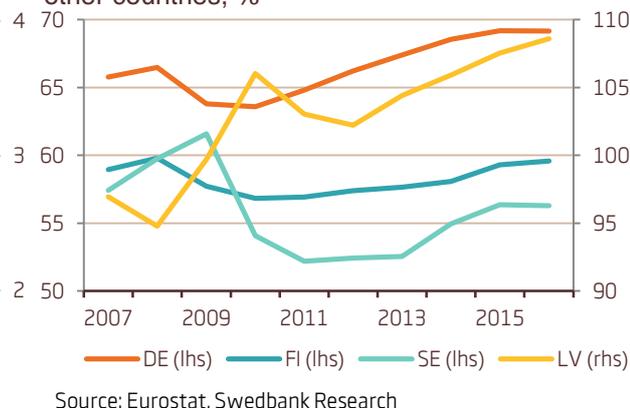
Economist:

Tõnu Mertsina, Chief Economist (Estonia), tonu.mertsina@swedbank.ee, +372 888 7589

Export market shares of goods, %



Estonian GDP price level compared to other countries, %



¹ The current analysis is of exports of goods. Although the share of goods in total exports to Finland (56% in 2017) is considerably lower than the average of all countries, the share has increased since 2015. Another reason for analysing exports of goods is the availability of more detailed data.

Finland is Estonia's largest export partner

Finland is Estonia's largest export partner. In 2017, Estonia exported EUR 2.1 billion (including EUR 1.7 billion of Estonian origin) goods to Finland (in nominal terms). Exports of goods to Sweden exceeded exports to Finland in 2011-2016; however, the main reason was the robust acceleration of exports of mobile equipment to Sweden. Excluding the exports of these goods, Finland has been Estonia's largest export market (see Appendix). The average share of goods of Estonian origin exported to Finland was 82% during the last five years (2013-2017). The respective average share of all Estonia's export markets was 71%. However, although the share of Finland in total exports of goods has increased since 2015, it is still lower than it was before 2011. In 2017, the share of Estonia's exports of goods to Finland was 16%, whereas the share of export of goods of Estonian origin was even higher, at 18.5%.

Export of goods of Estonian origin is relatively concentrated by country, i.e., more than one-third of exports (36%) go to only two countries (Finland and Sweden), and roughly half go to four countries (Finland, Sweden, Germany and Latvia). Therefore, the majority of Estonia's exports are dependent on the economic conditions of, and import demand from, relatively few countries. Although Estonian enterprises have proven their adaptability and ability to redirect at least some share of their exports to other markets, if necessary, an economic shock and/or sharp drop of demand in these major export partners could have a considerable negative impact on the Estonian economy.

At the same time, Estonian exports of goods to Finland are the most diversified among the ten largest export partners. The largest product groups exported to Finland are electrical equipment, furniture, and articles of iron or steel (see Appendix). The share of the largest 5 products out of 1210 in exports of goods to Finland (CN 4-digit code) was 21% in 2017. The respective share of the largest 20 products was 50%.

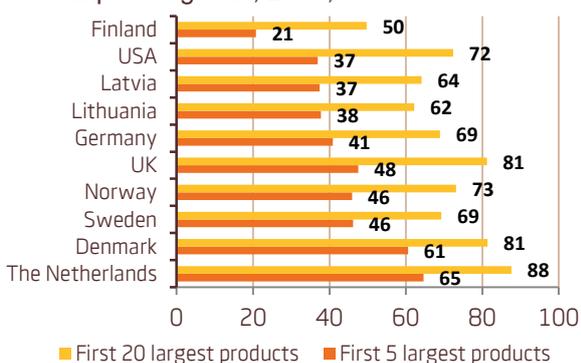
Finnish import demand is expected to remain strong in 2018

Since 2015, the growth of exports of goods to Finland has gradually picked up, along with the recovery of Finland's GDP growth and import demand. Last year, exports of goods to Finland increased 8.5% (export of goods of Estonian origin 9%) in nominal terms. Roughly two-thirds of the growth came from four product groups: electrical equipment, machinery and mechanical appliances, articles of iron and steel, and furniture.

In 2017, economic growth in Finland accelerated to 3%, the fastest pace of the last nine years. According to our forecast, Finland's GDP growth rate peaked last year and will slow in 2018 and 2019. However, we expect that in 2018 Finnish import demand will remain relatively strong and it should, at least in the near future, be among the largest contributors in foreign demand for Estonian exports of goods.

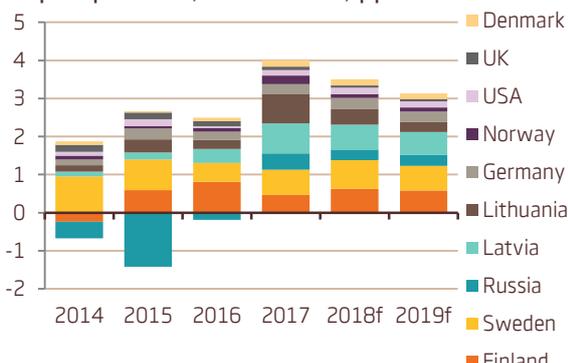
Production capacity and the turnover in Finland's business sector have expanded, whereas improved price competitiveness and stronger foreign demand are contributing to export growth. An increase in new orders in manufacturing confirms the continuation of both export growth momentum and import demand,

The share of the largest products in total export of goods, 2017, %



Source: Statistics Estonia, Swedbank Reserach

Import growth of Estonia's major export partners, contribution, pp



Source: Swedbank Research, European Commission

at least in the short term. Investment growth in construction is decelerating, while strong foreign demand, expanded production, and several major industrial projects will maintain robust growth in private investments. Private consumption has increased on account of households' diminishing saving rate. Increased consumer confidence, gradually rising employment, and decreasing unemployment rates are expected to maintain moderate household consumption.

The number of enterprises exporting to Finland has increased

The recovery of import demand from Finland has given export opportunities to more enterprises. The number of enterprises that export goods to Finland has increased during the last two years, reaching 1,756 in 2017 (see Appendix). This is approximately one-fourth of all Estonian enterprises exporting goods. The number of enterprises that import goods from Finland (1,952 in 2017) has always exceeded the number of exporting units. In 2017, the largest number of enterprises exported machinery and mechanical appliances (431), articles of plastics (412), and articles of iron and steel (390), whereas the largest average value per enterprise was in exports of electrical machinery and equipment and furniture. The least average value per enterprise was in exports of plastics and paper products.

Exported goods from Estonia have gained market share on the Finnish market

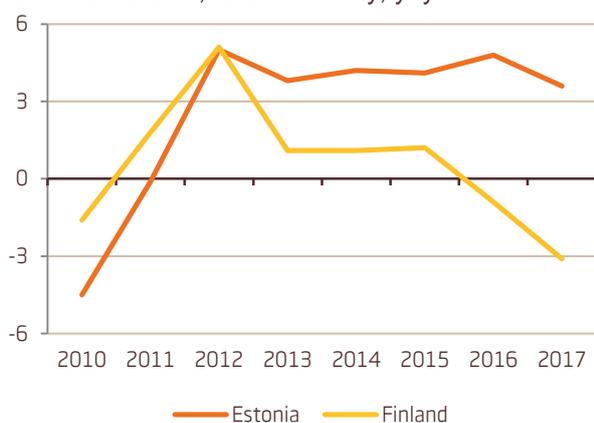
Although exported goods from Estonia lost some market share in Finland in 2017, the longer time series show a more positive picture. Estonia has gradually gained market share in Finland since 2008 – whereas in 2007 the share of Estonian exports of goods in Finland was 2.4%, in 2017 it increased to 3.4%. During the same period, imported goods from Finland did not gain market share in Estonia (the share was 14.1% in 2017) (see graph on the first page).

Estonia is losing its price competitiveness against Finland

In recent years, Finland has been able to limit the growth of its labour costs. Compared with Estonia's fast growth of labour costs, labour costs in Finland have been relatively stable (see Appendix). The gap between the growth of unit labour costs (the difference between labour costs and labour productivity) in Estonia and Finland has widened, as well. Finland has been especially successful in decreasing its unit labour costs and improving its price competitiveness against its trade partners.

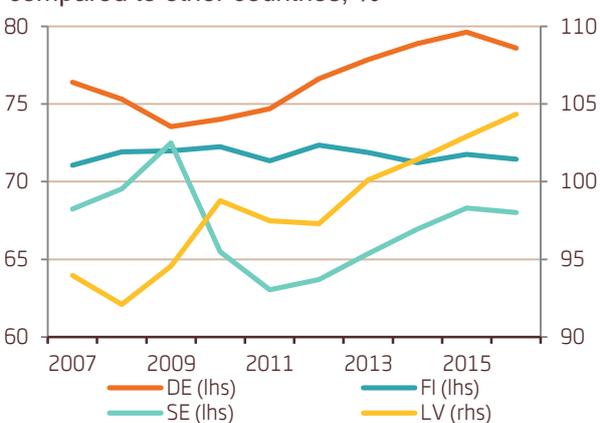
Estonian prices of goods have not converged closer to the Finnish average between 2007 and 2016, but it has lost its price competitiveness towards other major trade partners (e.g. Sweden, Germany and Latvia). Estonian prices of goods have stood at around 71-72% of the Finnish level². The main reason is that Estonian prices of capital goods have become cheaper than in Finland, while prices of consumer goods have converged closer to the Finnish average during that period. At the same time, Estonia has lost its

Unit labour cost, total economy, yoy %



Source: Eurostat

Estonian price level of goods compared to other countries, %



Source: Eurostat, Swedbank Research

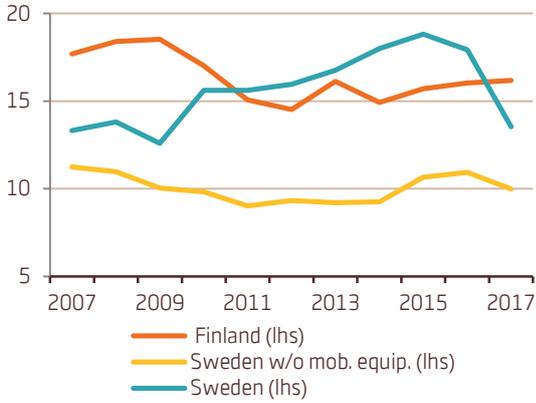
² The price comparison has been calculated based on the respective countries' price level indices, EU28=100

price competitiveness of capital goods compared to Latvia, Sweden and Germany. Services' prices made a U-turn in 2011 and have subsequently moved closer to services' prices in Finland. The gap between services' prices in Estonia and Finland is considerably wider than the difference in the prices of goods. If we look at more generally – the total economy – Estonian GDP price level has gradually converged closer to the Finnish average in the last years (see graph on the first page).

Estonia has gradually lost its price competitiveness against Finland and raising its exported goods' share on that market may gradually become more challenging. Thus, investing more in product development and productive capital and improving corporate management, work organisation, and supply chains are needed to halt Estonia's decline in price competitiveness on the Finnish market—let alone improve it.

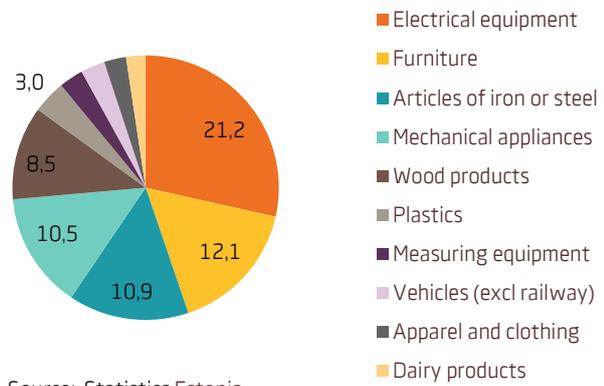
Appendix

Estonian export share of goods, %



Source: Statistics Estonia

Major goods exported from Estonia to Finland (local production) in 2017, %



Source: Statistics Estonia

Exports and GDP real growth, %



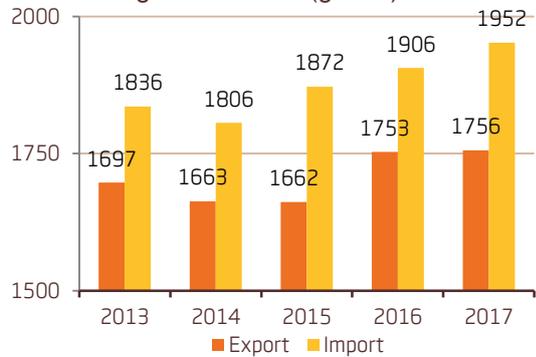
Source: Statistics Estonia, Eurostat, Swedbank Research

Labour costs in manufacturing, 2012=100



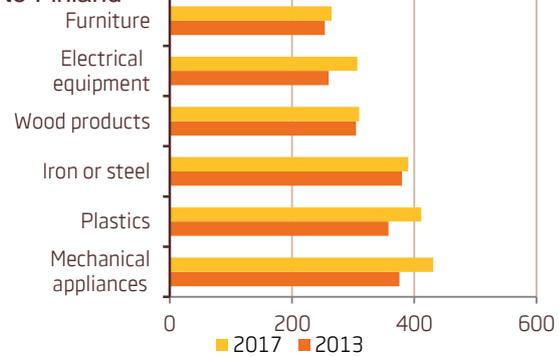
Source: Eurostat

The number of enterprises in Estonia trading with Finland (goods)



Source: Statistics Estonia

The number of enterprises exporting to Finland



Source: Statistics Estonia

Swedbank Research's disclaimer

What our research is based on

Swedbank Macro Research, a unit within Large Corporates & Institutions, bases the research on a variety of aspects and analysis.

For example: A fundamental assessment of the cyclical and structural economic, current or expected market sentiment, expected or actual changes in credit rating, and internal or external circumstances affecting the pricing of selected FX and fixed income instruments.

Based on the type of investment recommendation, the time horizon can range from short-term up to 12 months.

Recommendation structure

Recommendations in FX and fixed income instruments are done both in the cash market and in derivatives.

Recommendations can be expressed in absolute terms, for example attractive price, yield or volatility levels. They can also be expressed in relative terms, for example long positions versus short positions.

Regarding the cash market, our recommendations include an entry level and our recommendation updates include profit and often, but not necessarily, exit levels. Regarding recommendations in derivative instruments, our recommendation include suggested entry cost, strike level and maturity.

In FX, we will only use options as directional bets and volatility bets with the restriction that we will not sell options on a net basis, i.e. we will only recommend positions that have a fixed maximum loss

Analyst's certification

The analyst(s) responsible for the content of this report hereby confirm that notwithstanding the existence of any such potential conflicts of interest referred to herein, the views expressed in this report accurately reflect their personal views about the securities covered. The analyst(s) further confirm not to have been, nor are or will be, receiving direct or indirect compensation in exchange for expressing any of the views or the specific recommendation contained in the report.

Issuer, distribution & recipients

This report by Macro Research, a unit within Swedbank Research that belongs to Large Corporates & Institutions, is issued by the Swedbank Large Corporates & Institutions business area within Swedbank AB (publ) ("Swedbank"). Swedbank is under the supervision of the Swedish Financial Supervisory Authority (Finansinspektionen).

In no instance is this report altered by the distributor before distribution.

In Finland this report is distributed by Swedbank's branch in Helsinki, which is under the supervision of the Finnish Financial Supervisory Authority (Finanssivalvonta).

In Norway this report is distributed by Swedbank's branch in Oslo, which is under the supervision of the Financial Supervisory Authority of Norway (Finanstilsynet).

In Estonia this report is distributed by Swedbank AS, which is under the supervision of the Estonian Financial Supervisory Authority (Finantsinspektsioon).

In Lithuania this report is distributed by "Swedbank" AB, which is under the supervision of the Central Bank of the Republic of Lithuania (Lietuvos bankas).

In Latvia this report is distributed by Swedbank AS, which is under the supervision of The Financial and Capital Market Commission (Finanšu un kapitāla tirgus komisija).

This document is being distributed in the United States by Swedbank AB (publ) and in certain instances by Swedbank Securities U.S. LLC ("Swedbank LLC"), a U.S. registered broker dealer, only to major U.S. institutional investors, as defined under Rule 15a-6 promulgated under the US Securities Exchange Act of 1934, as amended, and as interpreted by the staff of the US Securities and Exchange Commission. This investment research is not intended for use by any person or entity that is not a major U.S. institutional investor. If you have received a copy of this research and are not a major U.S. institutional investor, you are instructed not to read, rely on or reproduce the contents hereof, and to destroy this research or return it to Swedbank AB (publ) or to Swedbank LLC. Analyst(s) preparing this report are employees of Swedbank AB (publ) who are resident outside the United States and are not associated persons or employees of any US registered broker-dealer. Therefore the analyst(s) are not subject to Rule 2711 of the Financial Industry Regulatory Authority (FINRA) or to Regulation AC adopted by the US Securities and Exchange Commission (SEC) which among other things, restrict communications with a subject company, public appearances and personal trading in securities by a research analyst.

Any major U.S. Institutional investor receiving the report, who wishes to obtain further information or wishing to effect transactions in any securities referred to herein, should do so by contacting a representative of Swedbank LLC. Swedbank LLC is a U.S. broker-dealer registered with the Securities and Exchange Commission and a member of Financial Industry Regulatory Authority and the Securities Investor Protection Corporation. Its address is One Penn Plaza, 15th Fl., New York, NY 10119 and its telephone number is 212-906-0820. For important U.S. disclaimer, please see reference: <http://www.swedbanksecuritiesus.com/disclaimer/index.htm>

In the United Kingdom this communication is for distribution only to and directed only at "relevant persons". This communication must not be acted on – or relied on – by persons who are not "relevant persons". Any investment or investment activity to which this document relates is available only to "relevant persons" and will be engaged in only with "relevant persons". By "relevant persons" we mean persons who:

- ◇ Have professional experience in matters relating to investments falling within Article 19(5) of the Financial Promotions Order.
- ◇ Are persons falling within Article 49(2)(a) to (d) of the Financial Promotion Order ("high net worth companies, unincorporated associations etc").
- ◇ Are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) – in connection with the issue or sale of any securities – may otherwise lawfully be communicated or caused to be communicated.

Limitation of liability

All information, including statements of fact, contained in this research report has been obtained and compiled in good faith from sources believed to be reliable. However, no representation or warranty, express or implied, is made by Swedbank with respect to the completeness or accuracy of its contents, and it is not to be relied upon as authoritative and should not be taken in substitution for the exercise of reasoned, independent judgment by you.

Be aware that investments in capital markets – such as those described in this document – carry economic risks and that statements regarding future assessments comprise an element of uncertainty. You are responsible for such risks alone and we recommend that you supplement your Decision-making with that material which is assessed to be necessary, including (but not limited to) knowledge of the financial instruments in question and the prevailing requirements as regards trading in financial instruments.

Opinions contained in the report represent the analyst's present opinion only and may be subject to change. In the event that the analyst's opinion should change or a new analyst with a different opinion becomes responsible for our coverage of the company, we shall endeavor (but do not undertake) to disseminate any such change, within the constraints of any regulations, applicable laws, internal procedures within Swedbank, or other circumstances.

If you are in doubt as to the meaning of the recommendation structure used by Swedbank in its research, please refer to "Recommendation structure".

Swedbank is not advising nor soliciting any action based upon this report. If you are not a client of ours, you are not entitled to this research report. This report is not, and should not be construed as, an offer to sell or as a solicitation of an offer to buy any securities.

To the extent permitted by applicable law, no liability whatsoever is accepted by Swedbank for any direct or consequential loss arising from the use of this report.

Conflicts of interest

In Swedbank Research, a unit within LC&I, internal guidelines are implemented in order to ensure the integrity and independence of the research analysts.

For example:

- ◇ Research reports are independent and based solely on publicly available information.
- ◇ The analysts are not permitted, in general, to have any holdings or any positions (long or short, direct or via derivatives) in such Financial Instruments that they recommend in their investment analysis.
- ◇ The remuneration of staff within the Swedbank Research department may include discretionary awards based on the firm's total earnings, including investment banking income. However, no such staff shall receive remuneration based upon specific investment banking transactions.

Planned updates

An investment recommendation is normally updated twice a month.

Reproduction & dissemination

This material may not be reproduced without permission from Swedbank Research, a unit within Large Corporates & Institutions. This report is not intended for physical or legal persons who are citizens of, or have domicile in, a country in which dissemination is not permitted according to applicable legislation or other Decisions.

Produced by Swedbank Research, a unit within Large Corporates & Institutions, Stockholm.

Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Malmkillnadsgatan 23, 111 57 Stockholm.