The Estonian Economy

Foreign direct investment – better, but there is capacity for more

- Estonia is still among largest net beneficiaries from FDI in the EU
- Increased inflow of FDI may boost fixed capital formation in the near future
- FDI by country becomes more and more diversified

Can FDI boost enterprises' investments into fixed assets?

Although there is no one-to-one link between FDI and investments into fixed assets, long-term comparison shows that there is evidence of correlation between these indicators, especially in manufacturing sector where the need for fixed assets is greater. Inflow of FDI has been gaining speed for the past two years and industrial confidence is improving. This suggests that we could start to see more investments into fixed assets soon.

Structure of Estonian FDI by sectors

Financial and insurance activities, that used to make up 50% of FDI back in 2005, are giving way to other sectors. The importance of manufacturing sector as receiver of FDI is also decreasing because of structural changes in the economy. Currently real estate activities make up more than 18% of FDI, more than during the previous real estate boom in 2007. Although the growth of FDI in professional, scientific and technical activities has recently been lagging it is important for the future.

FDI diversification by country has increased

Sweden has been a major contributor to our FDI from the beginning of independence, and it still is today, although the importance of Sweden is continuously decreasing. After the start of the conflict in Ukraine the FDI market share of Russia is also decreasing whereas other smaller countries, such as neighboring Latvia and Lithuania, invest more in Estonian companies year by year. Nevertheless more than 80% of inward FDI in Estonia originates from the EU.
Foreign direct investment – better, but there is capacity for more

For the past four years, investments in fixed capital in Estonia have been lagging. This is linked with rising labour costs, decrease in prices, and poor foreign demand, mainly because, as the Estonian economy is very small and open, it depends heavily on the economies of its export partners. Although there is no one-to-one link between gross fixed capital formation and foreign direct investment (FDI), the latter still contributes importantly to economic growth. This edition of the Estonian Economy takes a closer look at inward FDI to Estonia.

Can FDI boost investments into fixed assets?

When we refer to a lack of investments in the Estonian economy, we usually talk about investment in the real economy, a transaction contributing to GDP, i.e., the output of an economy. Inward FDI can be considered as an input to the economy that might be used to generate more output. Foreign direct investment (FDI) can be used to generate more fixed capital formation; however, it can also be used to cover other expenses or debt.

It is quite difficult to find the exact contribution of FDI to investments in fixed capital, but if we look at these figures’ proportions in GDP, we can see some correlation between them. This is especially true for the manufacturing sector, which has more fixed assets than other, more services-based sectors. This means that, if the inflow of FDI is increasing, we could also expect an increase in enterprises’ investments in fixed assets. Financial and insurance activities make up a large proportion of FDI in Estonia, but these corporations rarely make investments in fixed assets directly. In order to better assess the connection between FDI and fixed investments, it is wise to look at figures excluding the financial and insurance sector. FDI inflow excluding the financial sector has been increasing relative to GDP for quite some time now, but investments in fixed assets are standing still in the manufacturing sector and decreasing in total. There is also a positive correlation between FDI and GDP growth, although the causality runs both ways. More FDI contributes to economic growth and more growth brings additional FDI. The continued growth of FDI inflow contributes to increased investments in fixed assets.

Some countries, such as Luxembourg and Ireland, have large numbers for FDI stock because they serve mainly as financial intermediaries. Estonia cannot be considered as a tax haven; therefore, foreign entities that make investments in Estonia are largely engaged in real business activities. One incentive for foreign companies to invest in Estonia is the abolition of the income tax on reinvested earnings in 2000, which is promising potentially greater rewards in the longer term. In 2016, Estonia was ranked 9th in the Global Competitiveness Report as having the least restrictive rules and regulations on FDI. The future, however, is somewhat a concern due to government reform plans. At the moment, reinvested earnings will remain tax free; however there will be more bureaucracy due to the imposition of a deposit tax on intercompany loans that might inhibit FDI inflow. Comparing FDI net positions reveals that Estonia ranks quite high as a net beneficiary from FDI in the European Union. Foreign entities have invested EUR 12 billion more in Estonia than Estonian enterprises have made investments abroad. That is roughly 58% of GDP. This number started to decrease in 2009 but has now stabilised.
A high FDI-to-GDP ratio can be especially beneficial during periods of crisis, as direct investments are more closely tied into the Estonian economy than other type of foreign investments (e.g., portfolio investments). Even during the 2008-2009 financial crisis, FDI stock relative to GDP did not decrease. Nominal FDI stock and FDI inflow somewhat decreased, but only marginally compared with the decrease in GDP. This increases one’s confidence that during a crisis the Estonian economy will be more stable.

Structure of Estonian FDI by sectors

Financial and insurance activities make up a large proportion of FDI in Estonia, and, as a result, the vast majority of the Estonian financial and insurance sector is based on foreign capital. However, the proportion of the financial sector in total FDI stock dropped from 50% in 2005 to 28% in 2016 as FDI into other sectors caught up.

Besides financial and insurance activities, real estate, manufacturing, wholesale/retail trade, and professional activities are among the most important economic activities for FDI. Together, they make up 80% of total FDI stock. The importance of manufacturing sector FDI in total stock is slowly decreasing, partly due to long-term structural changes in the economy towards a more services-based economy. Productivity growth in the industrial sector has slowed. Estonian labour force is not as cheap as it used to be, but has not reached the level of northern Europe as yet. Therefore the driver for making an investment must be a mix of knowledge and cost savings Estonia has to offer.

The real estate sector has gained even greater importance than during the last real estate boom, making up 18% of the total stock. During that boom, many small building contractors seized business opportunities in the “ever-rising” market. Today, there is substantial amount of building activity, but the majority of it is performed by large international building companies, using more own funds and less loans. FDI in professional, scientific and technical activities started to grow in in 2007, making up 13% of the total stock in 2009. Although the growth of investments linked to research and development in total stock has been lagging in recent years, they are especially important to raise the value added of production in Estonia over the long term.

The inward flow of FDI in different sectors shows that, during the previous couple of years, direct investments in the manufacturing and professional activities sectors have started to contribute positively, whereas wholesale and retail trade investment flow has slowed. At the same time, we can observe similar trends in the respective confidence indicators of these sectors.
Although private consumption has been the main engine for economic growth for some time, this trend might soon turn. In retail trade, the competition for customers is getting intense. The amount of shopping-centre space per capita in Estonia is 1.36 square meters, which is more than the EU average, even though Estonia’s purchasing power is about 75% of the EU average. In recent years, purchasing power has increased due to very high wage growth, but this is also pushing up personnel costs for the stores. At the moment, we cannot see any major changes to the market. There is speculation about the entry of new brands, but at the same time others are making plans to leave. Foreign demand for industrial products has already improved, thus pushing up confidence, attracting new FDI, and, it is expected to contribute more to gross fixed capital formation in the future.

**FDI diversification by country has increased**

Similarly to Estonia’s export structure, Sweden and Finland are major contributors to Estonia’s inward FDI. About 50% of total FDI stock originates from these two countries. Since the financial crisis, we have seen a gradual change in the country-specific structure of FDI. The importance of Sweden is lessening, whereas other countries are emerging. Neighboring Latvia and Lithuania have started to invest more in Estonian companies. Russian direct investment stock in Estonia started to decrease after the start of the Ukrainian conflict and the sanctions that followed. Also, direct investments from the Netherlands, which grew very quickly during the crisis, have little by little lost share in total FDI stock. Nevertheless, more than 80% of FDI comes from the European Union. During the financial crisis, the importance of the European Union as a source of FDI lessened, but it has started to increase again as Russia’s influence on FDI decreases.

The concentration of FDI by country has been decreasing since 2006, meaning that more countries are contributing more equally to FDI in Estonia. The Herfindahl-Hirschman index (HHI) is a measure of concentration, used primarily in business, to assess the concentration of markets, but this index can easily be used to measure the concentration of FDI by countries. By the U.S. Department of Justice’s definition, a market with an HHI lower than 1500 is considered to be competitive. Therefore, it can be said that the division of FDI by country is sufficient. Greater division reduces the risk of a single event having major consequences for FDI, thus keeping FDI more stable.
FDI has played an important role in the Estonian economic model. Estonia is facing challenges with the transition to a more services-based economy - high employment number and a shortage of specialists in certain areas, together with a rise in unemployment. It is essentially a mismatch between demand and supply of skilled labour force. These challenges are the primary cause of the high wage growth. Higher wages mean that other factors, such as access to qualified labour, infrastructure, and simple taxation, become more important. In the FDI context, it is, on one hand, important to invest in automatic machinery and digitalisation in the industrial sector to improve productivity. On the other hand, investments in people and science-related activities are necessary to maintain the pace of moving forward.

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