

Macro Focus

Construction in Baltics will rebound for now

- Contraction is temporary
- Residential sector is stronger, at least in Estonia and Lithuania
- Construction costs will rise, but export potential is there

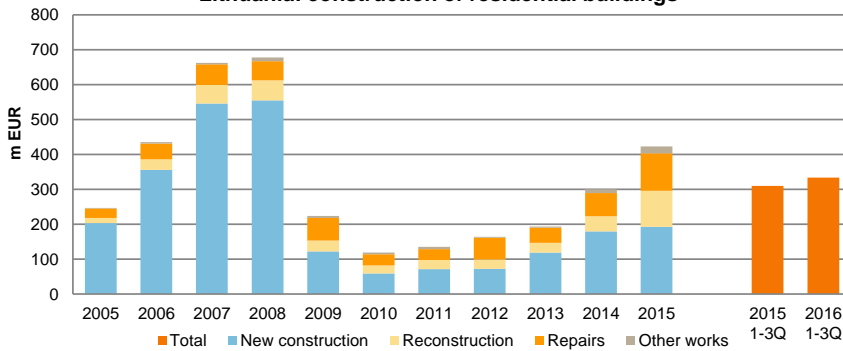
Contraction in construction sector due to temporary factors

The construction sector in the Baltics has lately been driven mostly by residential real estate projects. However, the sector has contracted because the weaker-performing nonresidential and civil engineering subsectors amount to 80-90% of the total value of construction works. The sector suffered least in Estonia due to a recovery in the construction of buildings. Construction contracted the most in Latvia as residential real estate there was contracting along with other subsectors. Civil engineering works (transport, energy infrastructure, etc.) are heavily dependent on public contracts and EU structural funds' support. Therefore, the main reason behind the contraction of the construction sector was the ending of support at the close of the previous EU funding programming period and the slow allocation thus far of funds from the new programming period. It is expected that this will not weigh on the construction sector in 2017.

Residential real estate will grow, but at a more modest pace

Nonresidential construction has been declining since 2015 in Latvia and Lithuania. Residential real estate construction has been more active in Lithuania than in Latvia. Nevertheless, in 2015 the expansion in Lithuania was mainly driven by reconstruction and repairs rather than new construction of residential buildings.

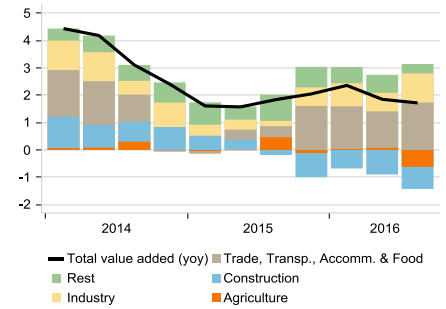
Lithuania: construction of residential buildings



Source: Statistics Lithuania and Swedbank.

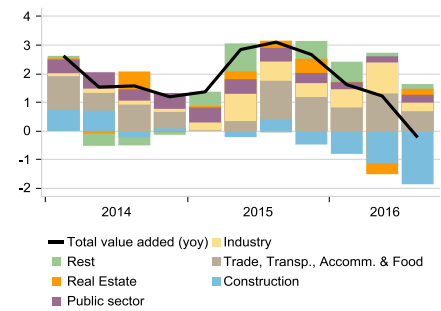
The value of the construction of buildings have been increasing this year in Estonia, also driven mostly by the residential sector. However, it seems that the momentum might now be lost as the market is not suffering as much from a lack of supply as earlier. The value of construction works in the Lithuanian residential real estate sector in 2016 did not grow as fast as in 2014 or 2015. However, the dynamics of building permit data suggests that this is most likely due to slower renovation rather than weaker development of new residential real estate. Nevertheless, we expect a more modest development of the residential real estate sector in Lithuania

Lithuania: contribution to growth



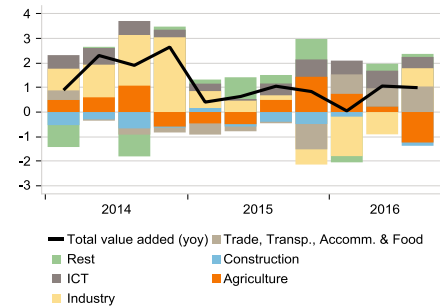
Source: Eurostat and Swedbank.

Latvia: contribution to growth



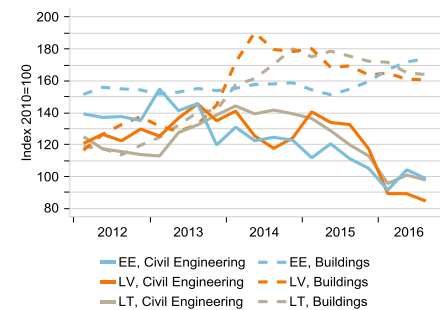
Source: Eurostat and Swedbank.

Estonia: contribution to growth



Source: Eurostat and Swedbank.

Value of construction works

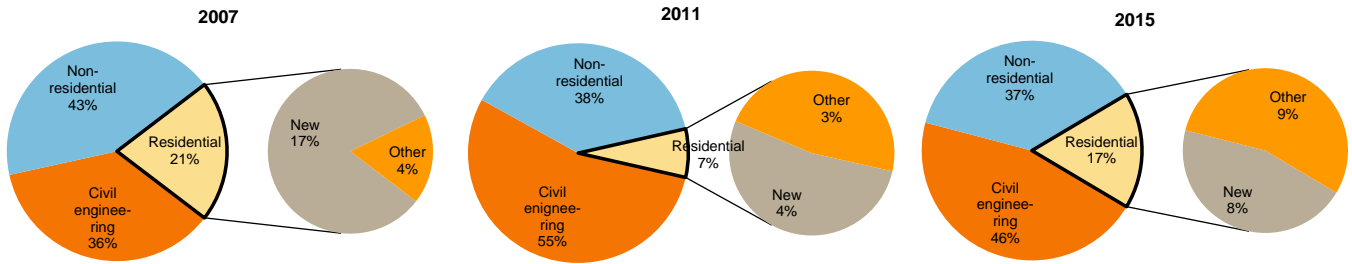


Source: Eurostat and Swedbank.

Analyst:
Vaiva Šečkutė
Email: vaiva.seckute@swedbank.lt
+370 5 258 2156

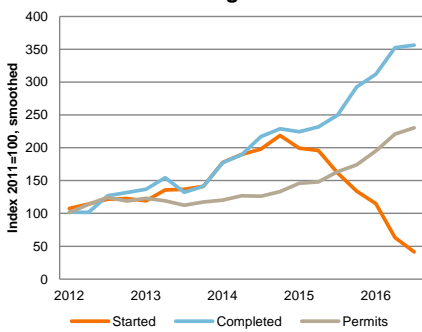
as well. The current supply of housing is adequate while employment growth is slowing down, and decreasing rent yields might also cool down expectations.

LT: share in total construction works



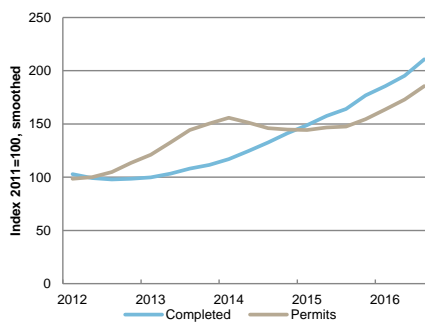
Source: Statistics Estonia and Swedbank

EE: number of dwellings



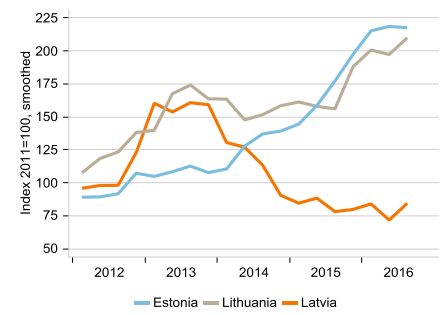
Source: Statistics Lithuania and Swedbank

LT: number of dwellings



Source: Statistics Estonia and Swedbank

Building permits (no. of dwellings) in residential buildings, except residences for communities



Source: Eurostat and Swedbank.

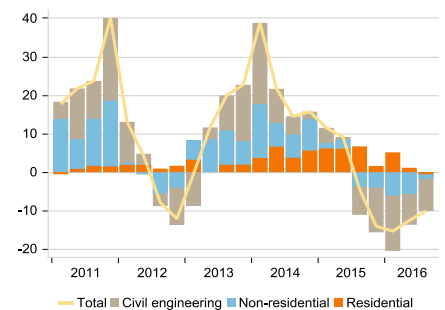
Nonresidential sector driven by service industry in Lithuania

Even though the value of construction works in the nonresidential building sector in Lithuania has been decreasing, in 2015 the main drag came from industrial buildings and warehouses, as well as schools, universities, and research center projects, while the expansion of offices and retail buildings remained rapid. The rapid expansion of the service center industry and the low office vacancy rates are the main drivers of the office sector expansion. Projects that are under construction or are planned indicate that office space in Vilnius might increase by 35% during the next couple of years. Judging from the levels of preleases, vacancy rates might temporarily jump, which could limit the growth potential for some time. Office space will be expanding in Kaunas as well to meet the growing demand.

Exports are booming in Lithuania

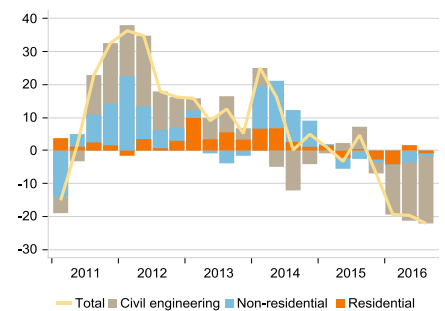
Growth of construction exports in the Baltic countries has been rapid during the last few years. The share of construction exports in GDP increased from 0.2% in 2008 to 0.6% in 2016 in Lithuania, and from 0.2% to 0.4% in Latvia. The share remains the largest in Estonia, where construction sector exports amounted to 1.6% of GDP in the first half of 2016. Since 2015, Lithuania has been increasing its exports the most. Lithuanian exports are also slightly less concentrated in any one market. Lithuanian exports increased recently due to growth in several markets, while Estonia exports about 40% of its construction services to Finland; meanwhile, in Latvia growth was driven by two markets (Lithuania and Sweden), whose shares have each been larger than 30% during the last few years.

LT: contribution to annual growth of construction works



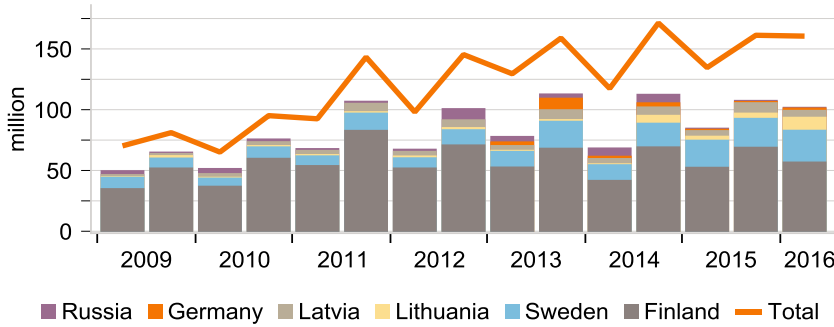
Source: Eurostat and Swedbank.

LV: contribution to annual growth of construction works



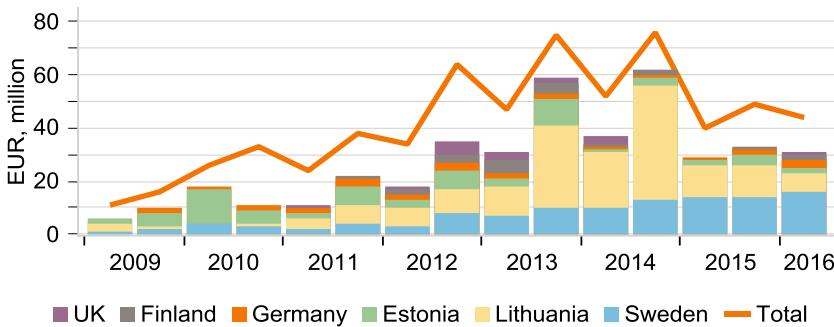
Source: Eurostat and Swedbank.

Estonia: construction export by countries



Source: Swedbank Research & Macrobond

Latvia: construction export by countries



Source: Swedbank Research & Macrobond

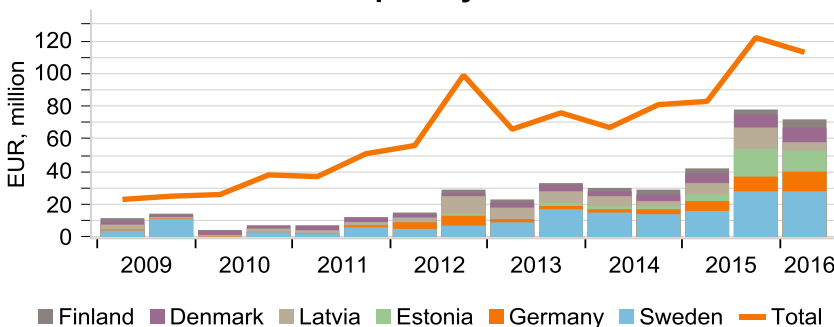
Exports destination shares in %

Estonia		2016 Jan-Jun
1	Finland	36%
2	Sweden	16%
3	Lithuania	7%
4	Latvia	4%
5	Germany	1%
6	Denmark	0.5%
Latvia		
1	Sweden	36%
2	Lithuania	16%
3	Germany	7%
4	France	5%
5	Finland	5%
6	Estonia	5%
Lithuania		
1	Sweden	25%
2	Estonia	12%
3	Germany	11%
4	Denmark	8%
5	Latvia	4%
6	Finland	4%

Source: Eurostat.

In Lithuania, the export share to Sweden also increased to 25% in 2016; however, growth was driven by more markets as a sizable share of exports went to several other countries (Germany, Estonia, Latvia, and Denmark). However, exports are growing from a low base, especially if compared with Estonia. This means that high growth rates are rather easy to achieve, and growth in some markets might still be the result of only a few, temporary projects. Nevertheless, once companies have entered the new market and build their reputations, it might become easier for them to find new projects in the future.

Lithuania: construction export by countries



Source: Swedbank Research & Macrobond

Costs are rising and labour market is hitting the limit

Construction costs stopped rising in Estonia in 2013, when they reached their pre-crisis peak. Construction costs have not been rising in Latvia for the last few years either, due to falling building material prices. In Lithuania, rising construction costs are mostly driven by rising wages.

It is probable that construction costs will rise in all three countries. Recently, construction sector wages were rising less than in other sectors

on average in Estonia and Latvia, they barely grew in the third quarter. Employment is falling in both countries. Lack of demand is the primary reason in Latvia, while the more pronounced lack of a qualified labour force is one of the main reasons in Estonia. The lack of qualified labour is an issue in Lithuania as well - wage growth accelerated in the construction sector despite weaker employment. In 2016, wage levels in the construction sector in Lithuania came close to the pre-crisis peak, while that peak was surpassed by some 20-25% in Estonia and Latvia. Lithuania has been actively employing workers from Ukraine and Belarus. In Lithuania, the number of immigrant workers from third countries rose to 14,600 in the first three quarters of this year - 2.4 times more than during the same period a year ago. This might have limited wage growth in Lithuania compared with other two Baltic states.

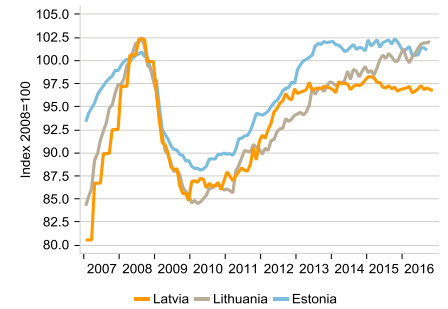
However, wage pressures are not likely to ease as demand will increase due to a more active use of EU support. Moreover, the rising vacancy rates and the fall in unemployment close to or below the natural level mean that companies most likely will feel pressure from both sides: rising costs due to higher commodity prices and wages and capacity constraints. It is also probable that wage growth will accelerate if companies need to employ more workers, as happened in Estonia in 2012 and in Latvia and in Lithuania mid 2013 – mid 2014.

Better times are not certain for long

The local market will offer more growth opportunities, at least in the civil engineering sector for the next few years, while cost competitiveness will worsen. However, the recent expansion of exports suggest that low costs most likely are not the only competitive advantage of the Baltic construction sector companies. Construction exports involve not only such construction works as civil engineering, but also the assembly of locally manufactured goods. For example, Lithuania has more than doubled its exports of wooden houses during the last few years to more than EUR 100 million. If more companies would be able to build brand by providing architectural and design services, rising labour costs would be much less of a threat to their competitiveness.

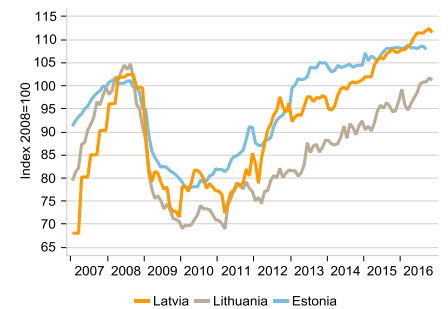
The share of Lithuanian and Latvian construction exports is still significantly smaller than that of Estonia's, and exports are likely to become one of the main growth drivers if market shares are won. After all, it is very likely that in the next decade the EU will offer much less support than the industry was used to. However, at this stage the success of the sector will also depend on the success of economic policy. The governments should focus on reforms to increase the potential of the labour market, including education, retraining programmes, and labour market regulation.

Construction cost index



Source: National statistics and Swedbank

Construction cost index: Labour



Source: National statistics and Swedbank

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Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
 Visiting address: Landsvägen 40, 172 63 Sundbyberg