

4 June, 2014

Newsletter

# The Estonian Economy

## Estonia's construction sector feeling gloomy

- Construction volumes will decrease in 2014
- Construction prices will stay at around last year's level
- Estonia has done better than its neighbours

### Construction volumes will decrease in 2014

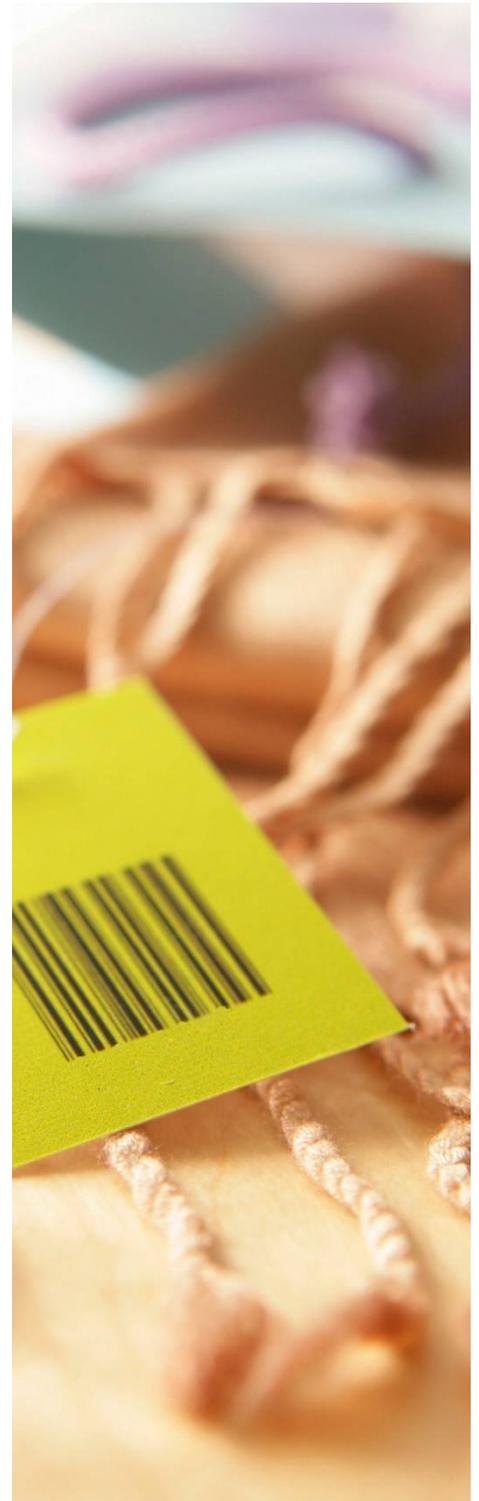
In 2014, construction volumes are expected to fall in Estonia. Current order books are below average, and employment in the sector is expected to decline. Residential construction will continue increasing at recent volumes, whereas non-residential construction and civil engineering works will decline. An increased supply of new or recently renovated apartments will, it is hoped, cool down the prices of real estate.

### Construction prices will stay at around last year's level

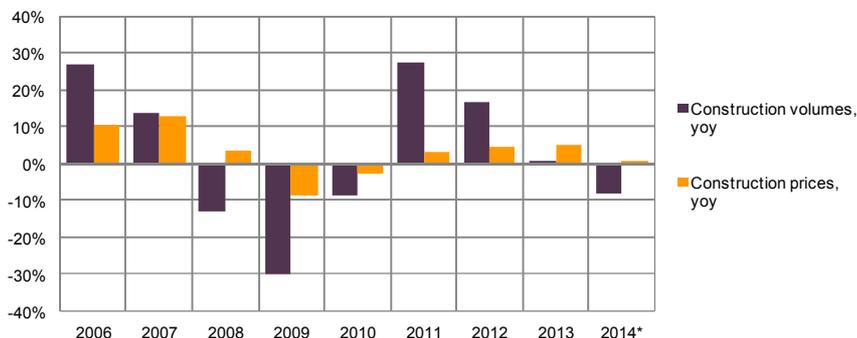
Lower construction volumes and intensified competition will put pressure on construction prices. Maintaining last year's profitability will be difficult in 2014. Mostly due to a fast increase in wages, construction prices are already above their pre-crisis peak in Estonia.

### Estonia has done better than its neighbours

Construction volumes and prices have increased more in Estonia than in other Baltic or Nordic countries since the last slump in 2009-2010. Public sector orders supported larger construction volumes in Estonia in 2011-2012. In 2013 and 2014, the share of the private sector in enterprises' order books has increased, while the volume of public procurement projects has declined, mostly due to a gap between the two EU funding periods.



### Construction sector's outlook



Source: Statistics Estonia, Swedbank's forecast

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## Estonia's construction sector feeling gloomy

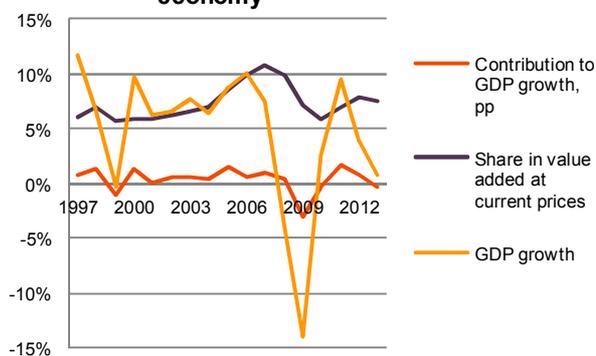
Construction volumes are expected to fall in Estonia in 2014. Maintaining last year's profitability will be difficult. Residential construction will continue growing at recent volumes, whereas nonresidential construction and civil engineering works will decrease. An increased supply of new or recently renovated apartments will, it is hoped, cool down the prices of real estate.

### Construction volumes will decrease this year

Construction is the fourth-most-important sector in Estonia in terms of value added, after manufacturing, trade, and real estate. In 2013, construction's share in Estonia's value added was 7.5%, at current prices. The sector employed 57,000 persons, i.e., 9.1% of the total employed last year. More than half of Estonia's construction workers erect buildings; the other half are involved in infrastructure development and special construction projects. Around 10,000 of Estonia's construction workers are employed in Finland, according to official data; the number is probably bigger in reality.

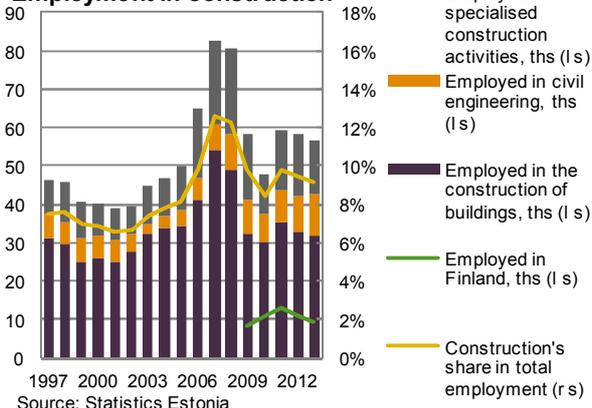
**Construction forms 8% of the value added and 9% of the employment**

**Construction's share in Estonia's economy**



Source: Statistics Estonia

**Employment in construction**

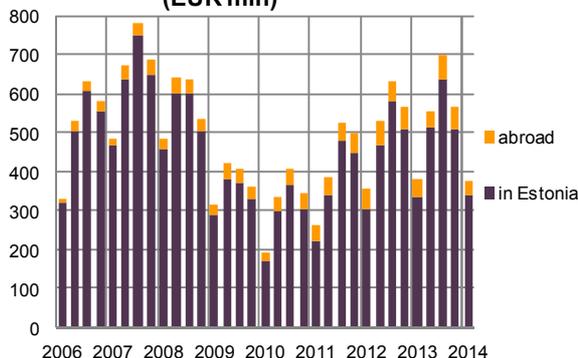


Source: Statistics Estonia

In 2013, construction production totalled EUR 2.2 billion, out of which EUR 2.0 billion was carried out in Estonia and EUR 0.2 billion abroad. In the first quarter of 2014, construction volumes amounted to EUR 376 million, of which building construction was EUR 254 million and civil engineering works (roads, bridges, electricity, and communication networks) EUR 122 million. The volume of construction declined by 3.4% in the first quarter, in real terms, year on year. The volume of building construction grew by 4%, and the volume of civil engineering works decreased by 15%.

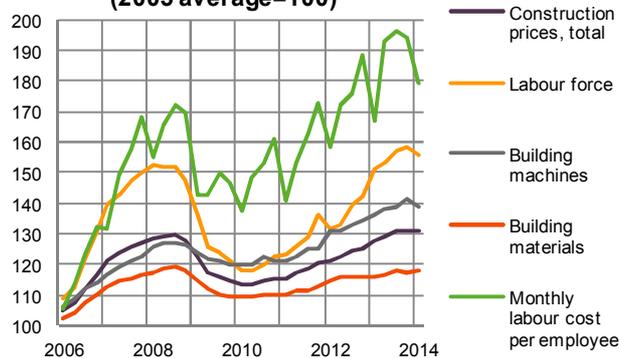
In Estonia, in the first quarter of this year, the volume of the construction of new buildings continued increasing, while the repair and reconstruction of buildings stayed at last year's level. The construction of civil engineering objects, which supported the construction market for nearly three years, has decreased for two quarters. The construction volumes of Estonian construction enterprises in foreign countries continued decreasing, amounting to 10% of their total volume of construction in the first quarter of 2014. In 2014 as a whole, construction volumes are expected to decrease due to fewer civil engineering works.

### Construction activities at current prices (EUR mln)



Source: Statistics Estonia

### Construction price index in Estonia (2005 average=100)



Source: Statistics Estonia

## Construction prices will stay at around last year's level

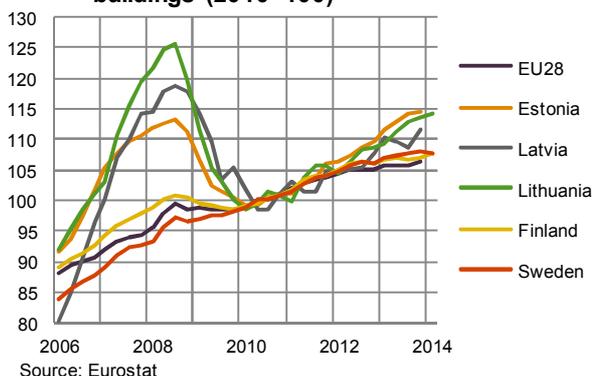
Decreasing volumes of construction and stronger competition affect construction prices. The prices of construction<sup>1</sup> shrank for the first time in three years on a quarterly comparison in the first quarter of this year (-0.1%, quarter on quarter). The three components of the construction price index moved as follows: labour costs decreased by 1.5%, costs of building machines declined by 1.8%, and costs of building materials increased by 0.7%.

In an annual comparison, the construction price index increased by 2.4% in the first quarter. Labour costs covered in the index grew by 3.0%. At the same time, in the sector as a whole (including white-collar workers and other construction subsectors, like civil engineering and specialised construction activities not covered in the construction price index), labour costs increased much faster, as the monthly labour cost per employee jumped by 7.2% and the number of employed increased by 4.7%, year on year. Mostly due to a fast increase in wages, construction prices are already above their pre-crisis peak. In connection with the smaller construction volumes and intensified competition, construction prices are expected to stay at around last year's level in 2014.

## Doing better than its neighbours

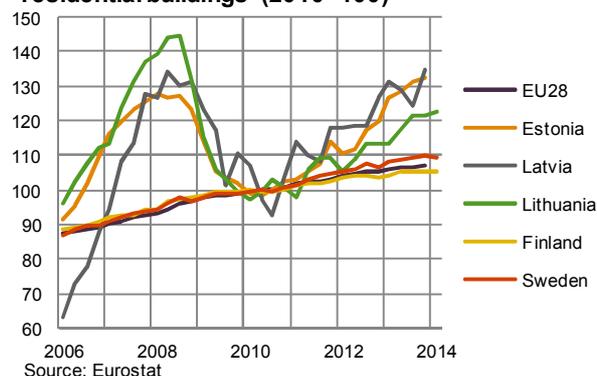
Since 2010, construction prices have increased more in Estonia than in its peers in the region (15.2% from the first quarter of 2010 to the last quarter of 2013). Estonia raced ahead of Lithuania, Latvia, and the more moderate Finland and Sweden. This is partly because of a fast increase in wages - labour costs have jumped by around 30% in Estonia's construction sector since 2010. Labour costs formed 17% of total costs in the sector in Estonia in 2013.

### Construction prices, new residential buildings (2010=100)



Source: Eurostat

### Labour costs in construction, new residential buildings (2010=100)

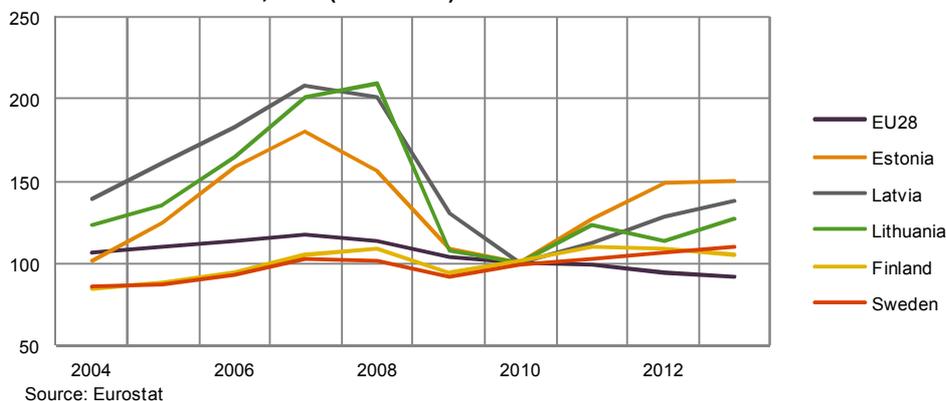


Source: Eurostat

Prices have also probably increased faster in Estonia because order books have looked better in Estonia than in other Baltic or Nordic countries. Eurostat figures show that construction volumes have improved the most in Estonia since the last slump in the sector in 2009-2010.

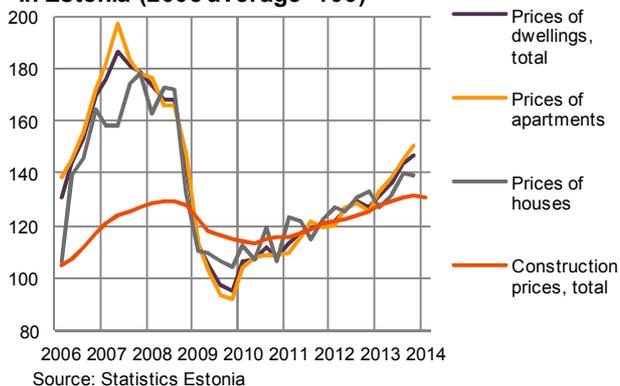
<sup>1</sup> The construction price index expresses changes in the costs of the construction of buildings, taking into consideration price changes in the three basic inputs: labour force, building materials, and building machines.

**Construction volumes, wda (2010=100)**

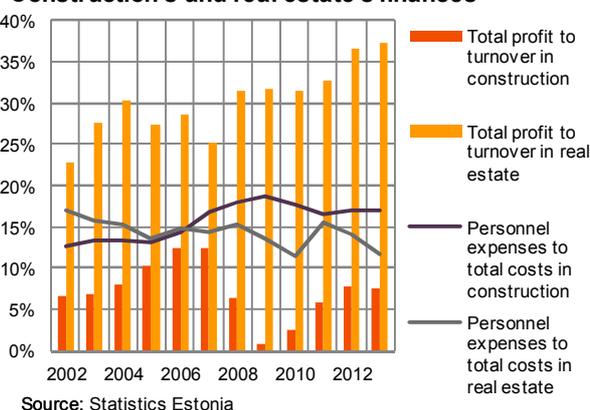


The growth of construction prices lagged the growth of dwelling prices in 2012 and, especially, in 2013. In the latter year, the prices of dwellings<sup>2</sup> increased by 10.7%, while the prices of construction grew by 5.2%. The profitability of real estate developers remained the highest among all economic sectors in Estonia. The ratio of profits to turnover in the sector reached 37.3% in 2013. In comparison, the ratio of profits to turnover in the construction sector in Estonia amounted to 7.6%, around the same level as in 2012. Construction enterprises have claimed that maintaining a similar profit margin will be difficult this year, especially in general construction, where competition is the tightest.

**Dwelling and construction prices in Estonia (2005 average=100)**



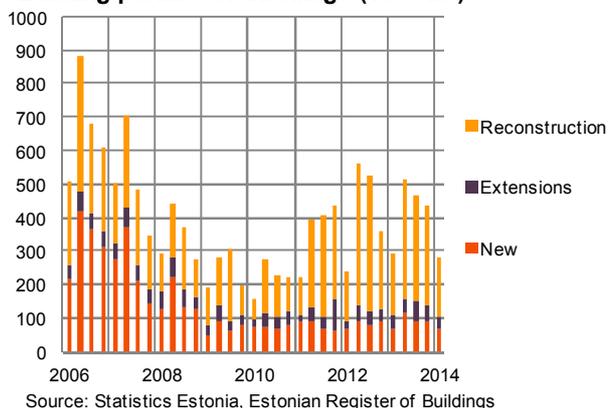
**Construction's and real estate's finances**



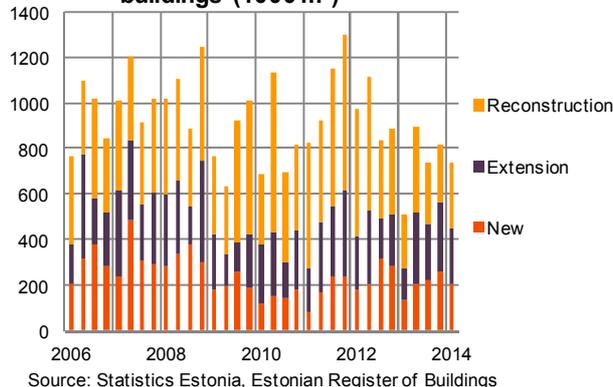
**Volumes of civil engineering projects will decrease**

Building permits data show that residential construction will continue at recent volumes in Estonia, whereas the volumes of nonresidential construction and civil engineering works will clearly decrease. An increased supply of new or recently renovated apartments will, it is hoped, cool down the prices of real estate. Based on data from the Register of Construction Works, in the first quarter of 2014, the number of dwelling completions was 748, i.e., 323 dwellings more than in the same period of 2013.

**Building permits of dwellings (1000 m<sup>2</sup>)**



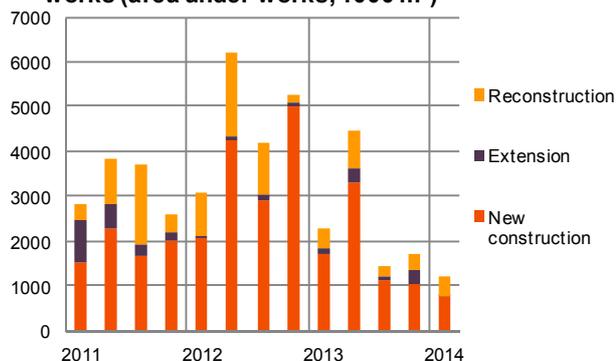
**Building permits of non-residential buildings (1000 m<sup>2</sup>)**



<sup>2</sup> Dwelling price index expresses changes in the square metre prices of dwellings purchased by households.

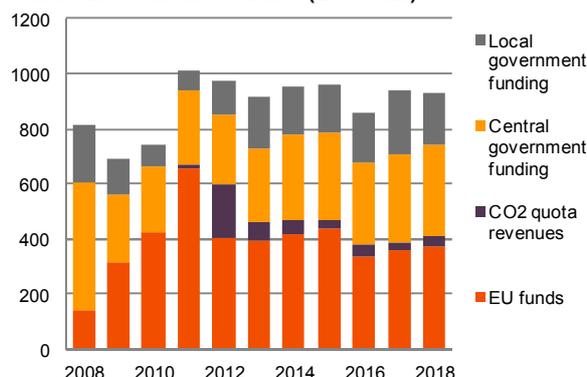
In 2013, the share of the private sector in enterprises' order books increased; meanwhile, the volume of public procurement projects declined due to a gap between the two EU funding periods of 2007-2013 and 2014-2020, and because of fewer projects related to CO<sup>2</sup> quota sales. According to the latest state budget strategy 2015-2018, the EU and CO<sup>2</sup> quota sales-related investments will stay at around the 2013 level in 2014-2015. According to the budget strategy, total public investments in tangible and intangible assets are expected to increase a bit in 2014 and stay around that level in 2015. However, building permits and Swedbank's own data show that infrastructure construction volumes will decrease this year.

**Building permits of civil engineering works (area under works, 1000 m<sup>2</sup>)**



Source: Statistics Estonia, Estonian Register of Buildings

**Public investment volumes (EUR mln)**



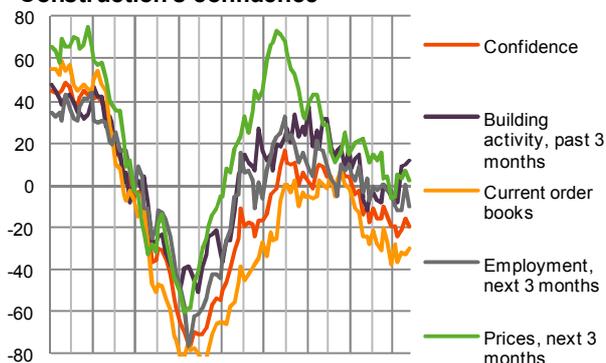
Source: Ministry of Finance, Statistics Estonia

EU funds will mostly be used in infrastructure development. Around EUR 100 million from central government funds will be used every year in the construction and renovation of dwellings, including building a new prison, courthouse, and national archive, as well as the Estonian National Museum and Pärnu police building, and renovating the Ugala Theatre and the Estonian History Museum. Other major construction projects in 2014-2015 include several shopping centres (Pro Kapital, Stroomi, Mustamäe, and the expansion of Ülemiste), the hotels of Hilton and Palace, the development of Ülemiste City, the renovation of Tallinn's tram line, the building of Smarten Logistics Centre, and the renovation of ERR Radio House, and others.

### Pessimistic about the future

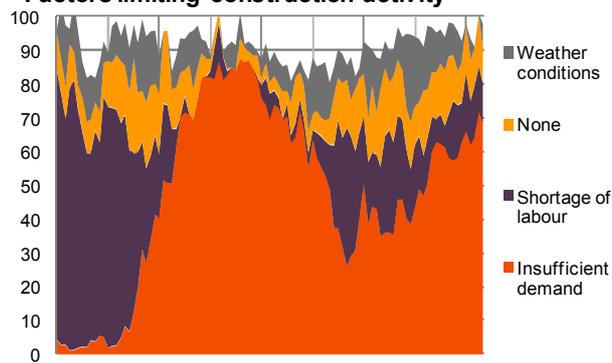
At the moment, the construction enterprises business outlook is rather gloomy. Despite favourable weather conditions this winter, the enterprises' confidence is at its lowest level in four years. Current order books are below average, employment in the sector is expected to decrease, and prices are staying at the current level. As in other sectors in Estonia, low demand is the main factor limiting business activity. In May this year, 69% of construction enterprises marked insufficient demand as their main business constraint, 12% of enterprises highlighted the shortage of labour, and 8% mentioned unfavourable weather conditions.

**Construction's confidence**



Source: DG ECFIN

**Factors limiting construction activity**



Source: DG ECFIN

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