Regional analysis Construction and real estate

Real estate cycle at turning point?

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Highlights – construction activity

Construction activity has been slowing down in North Macedonia, Bosnia and Herzegovina and Serbia, growing in Croatia and booming in Slovenia in 2H2022. Downtrend in countries with weaker numbers is already mirroring anticipation of subdued demand due to pandemic savings fading out and rising interest rates reflecting on funding. Croatia and Slovenia are still on their post-pandemic upward trend. Compared to 1H2022, in 2H2022 building permits show a decrease in yoy terms in the region, except in the case of Bosnia and Herzegovina, indicating slower construction activity in the short-run.

Croatia, Slovenia and Serbia construction sectors were on their 10y maximum production levels during the last two years, depicting activity peak. Bosnia and Herzegovina was just under 10y peak in the last two years, while North Macedonia showed lower construction production compared to its 10y high recorded in 2016. With each country carrying its own reasons behind, we are going through the details of construction industry movers per country in the following paragraphs.

Slovenia displayed most aggressive growth in construction activity in 2022, constantly beating previous year, posting around 29.1% growth in 3Q2022 yoy, with October and November-2022 data showing even faster pace. Building construction grew faster than civil engineering objects (90% vs 2%, in 3Q2022), as during 2020 and 2021 building construction was reduced, lowering the base. Building permits 2Q and 3Q dropped significantly, implicating slowdown in construction in further months (even though as residential demand is persistent, as is the case for the rest of the Adria region). In 4Q building permits increased 9.4% yoy, mitigating the 2022 drop to -6% yoy. Construction activity focus is mainly oriented towards infrastructure (giving the higher project values versus building construction), such as transportation (e.g. railways between Divča and Koper, which was recently prolonged to 2026), while significant funds are increasingly directed into energy infrastructure (especially given the recent geopolitical circumstances).

Construction activity
(yoy growth rates)

	1Q2022	2Q2022	3Q2022	latest*	2022**
HR	4.6	4.3	3.2	4.9	**4.2**
SI	21.8	25.2	29.1	50.2	**30.9**
MK	-11.2	-1.1	-19.2	-23.9	**-12.8**
BH	1.3	-1.7	-1.9	n/a	**-0.8**
RS	-6.3	-11.3	-13.8	n/a	**-11.0**

*latest available 2022 data (HR and SI October-November-2022, MK October-2022); **average of all 2022 data published ytd; Source: Eurostat and national statistical offices

Building permits, total
(yoy growth rates)

	1Q2022	2Q2022	3Q2022	latest*	2022**
HR	3.9	14.0	-1.6	-3.0	**3.7**
SI	3.6	-20.6	-12.9	9.4	**-6.0**
MK	-0.1	9.8	3.6	-20.5	**-1.8**
BH	2.3	1.6	-2.6	4.5	**1.4**
RS	28.2	4.2	-8.8	-19.6	**-1.8**

*latest available 2022 data (HR, MK and RS for October-November-2022, SI and BH for October-December); **average of all 2022 data published ytd; Source: National statistical offices

Highlights – construction activity

Construction sector in **Croatia** posted 3.2% yoy growth in Q3 2022, showing modest but the most stable growth in construction in the region. In October-November-2022 construction activity grew faster recording 4.9% yoy increase. Slight decrease in building permits during second half of 2022 is indicating a slowdown in further construction, though in 2022 Croatia posted 3.7% yoy increase. Last year's focus was mainly on large infrastructure projects (like Drava Bridge, Pelješac bridge, motor highway section on corridor Vc between Osijek and Beli Manastir, Hrvatski Leskovac-Karlovac railway) and thess dynamics should continue throughout 2023, given the excessive amount of EU funds available. Building construction, however, or, more precise, residential building construction will flatten as interest rates increase further and economic environment deteriorates, however some support will come from the Gov't, mainly in the form of assisted residential building of the earthquake-impacted areas. Negative risks for investments into new tourist capacities present in the form of expected challenging times ahead regarding international travel, new tax burden (in the form of windfall tax) and increasing cost of material/labour and funding.

In Bosnia and Herzegovina construction activity has been stagnating recording -1.9% yoy drop in 3Q2022, but -0.8 yoy rate in the first 9 months of 2022. Building permits were also mildly changing, mostly into the positive territory. The latest data on permit issuance indicates increase (4.5% yoy in 4Q2022) adding up to 1.4% yoy overall increase in 2022, giving us some positive hint regarding further development. Main infrastructural investments are tied to corridor Vc project, which was stalled due to paused funding inflows. The project is long-term and it's expected to lift construction in further periods. As the government is expected to be formed anytime soon, we see developments in infrastructure projects to boost construction sector in Bosnia and Herzegovina.

North Macedonia posted -19.2% yoy drop of construction activity in Q3 2022, mostly driven by civil engineering (-25.9% yoy) and less by building construction (-8.8% yoy). Construction sector has had challenging 2022 with one of the largest construction companies Beton AD entering the pre-bankruptcy phase due to mismanagement. Overall building permits have been decreasing in 2022, partially buffered with increase of industrial sites construction spike in 2H2022. Value of expected works has been driven by transport infrastructure, expected to pass to construction activity in 4Q2022 and 2023. Major projects are in development phase, backed up by EBRD funding (railway Corridor VIII sections worth EUR 275mln in loans and grants, Solid Waste Management project worth EUR 55mln in loans and various additional transport infrastructure investments).

Highlights – construction activity

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In Serbia we see continuous yoy drop in construction activity during 2022 (-13.8% yoy in 3Q2022), caused by slowing down after the intensive growth in post-pandemic period. There are signs of supply calming down, as building permit issuance is posting decline, dominantly in building construction area. After the lock-down period, building permits for houses rocketed, as demand for (mostly holiday) houses spiked. Avg monthly permits for this building type issued in 2021 and 2022 (up to November-2022) were around 80% higher in comparison to 2019. Although building permits are decreasing, they are still elevated and above historical trends. In recent years demand for dwellings was partially covered, although there are mixed signals present as inflow of Russians and urbanization trends are supporting demand. Infrastructure development is expected to remain forceful as major projects are on their way (Belgrade metro, national stadium, many transportation infrastructure projects etc.).

In tables on the right, we are going through the **list of factors limiting the construction activity** as according to the European Commission's Construction sentiment survey. **Tight labour market, disturbed supply chains and rising material prices, and U turn in monetary policies have spilled over to the construction sector too. Labour force shortage is seen as the most prominent constrain to construction development in the Adria region,** according to EC Business and consumer survey regarding construction for December-2022 (BH data not available)**.** On average, 2022 survey showed that shortage of labour force, materials and equipment was more pronounced compared with 2021. Insufficient demand was less significant limiting factor in 2022, compared to a year before. **General sign that contractors are gauging slowdown signals is seen in decreasing percentage of them indicating no limits to building activity.**

Main factors currently limiting building activity

(December-2022, % s.a, data doesn't add up to 100 due to multiple choice responses)

	HR	SI	MK	RS
None	13.7	10.3	9.3	20.8
Insufficient demand	11.5	5.3	28.5	11.9
Weather conditions	13.1	25.2	9.3	5.6
Shortage of labour force	46.2	57.7	38.4	23.1
Shortage of material and/or equipment	13.4	24.3	5.5	7.7
Other factors	11.9	70.7	12.3	10.6
Financial constraints	20.5	13.4	36.7	15.9

(2022 yoy change, pp s.a.)

	HR	SI	MK	RS
None	-4.6	-3.4	-4.0	-7.0
Insufficient demand	-3.8	-5.9	-9.8	-2.8
Weather conditions	-3.5	-7.8	0.0	-2.6
Shortage of labour force	6.9	15.8	6.4	1.6
Shortage of material and/or equipment	8.8	13.6	4.2	4.3
Other factors	-2.0	7.7	-5.1	0.7
Financial constraints	5.2	-0.3	13.0	4.2

Highlights – house prices

House prices are still booming, constantly showing two-digit growth rates all over the region, demonstrating still strong demand. Bearing in mind previous period of high inflation, housing market demonstrated value preserving role, as house prices grew faster than headline inflation in the region, except in Serbia where HICP increased in line with house prices in 3Q2022. Upswing in house prices in the post-pandemic period is still persistent, even though overall economic conditions have changed.

In all countries in the region house prices advanced in 3Q2022 faster than in the previous quarter, except in Slovenia which kept the same pace. Strong demand seen in recent years was supported by financial conditions (increasing employment and wages, and relatively low mortgage rates) and demographic trends (ongoing emigration to urban areas and increase in single person households). Bosnia and Herzegovina posted 47.5% yoy increase in house prices in 3Q2022, the highest spike in the region, followed by North Macedonia recording 20.6% yoy increase in 4Q2022. The rest of the region didn’t fall behind, with Slovenia showing 15.4% yoy, Croatia 14.8% yoy and Serbia 13% yoy in 3Q2022.

Even though 4Q2022 data is expected to point to still high growth in house prices, monetary tightening effects first and foremost, along with deterioration in overall economic condition secondly, will put downward pressure on house prices, depressing demand. More pronounced effects of these movements will be shown in the 1Q2023 data, while **negative fundamentals for house prices will materialize much more in the second part of 2023, hence reflecting the lag effect of real estate market to the general economic activity.**

House prices
(yoy growth rates)

	1Q2022	2Q2022	3Q2022	4Q2022*	2022*
HR	13.5	13.6	14.8		**14.0**
SI	16.9	15.6	15.4		**16.0**
MK**	12.4	16.5	21.2	20.6	**17.8**
BH***	24.9	36.6	47.5		**36.3**
RS****	12.1	12.8	13.0		**12.6**

*latest available 2022 data as of 3Q2022, for MK 4Q2022
**prices of advertised apartments for sale in Skopje
***prices of new dwellings
****RGA dwelling price index

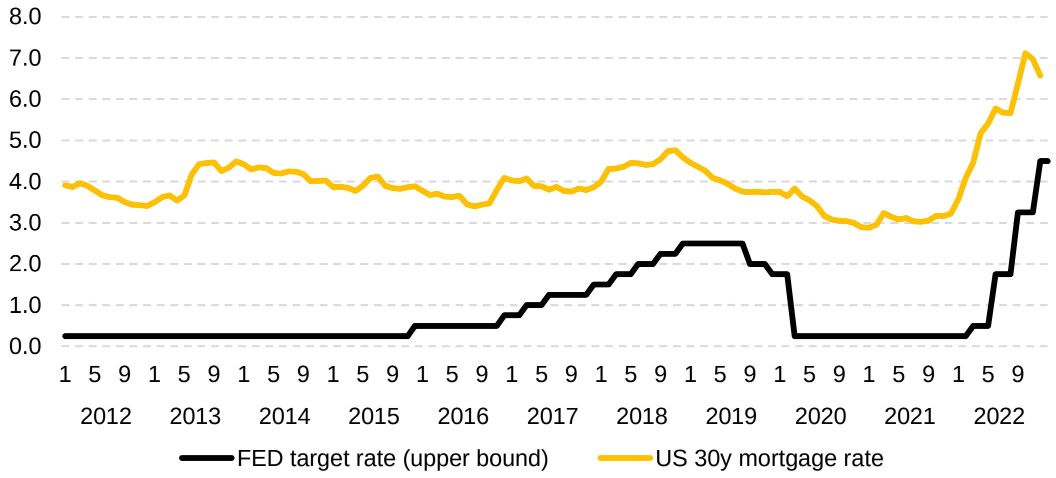
Special topic – interest rates

Global real estate markets are cooling, and we see similar scenario to pass to Adria region as well. Tightening monetary policies have been dragging down real estate market, acting twofold. In line with increasing living costs, landing standards have tightened, making funding for house purchase less affordable. Supply side has also seen financial constraints as funding investment projects became more expensive.

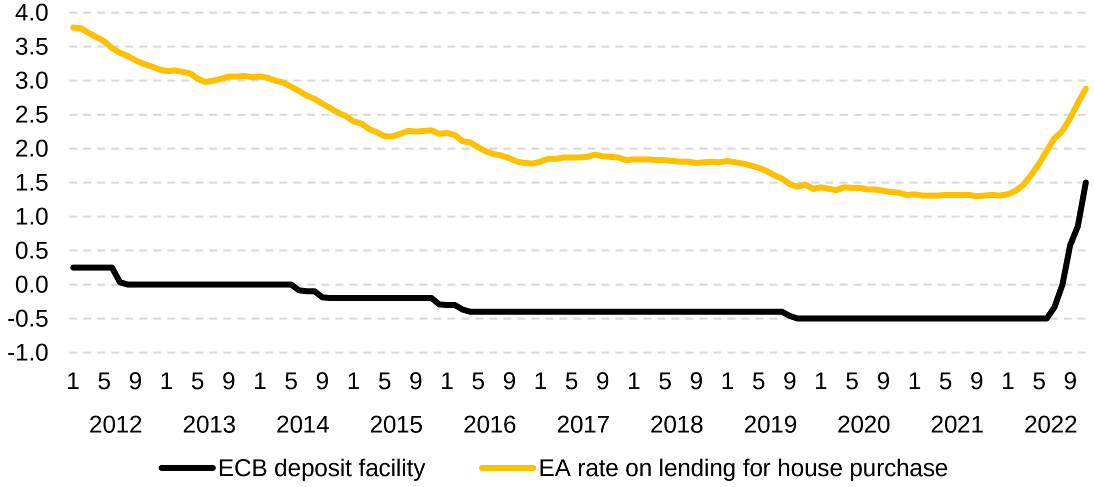
Firstly, we are taking a look into the US real estate market, which is moving quite fast along with the economic cycles and thus we see it as a good proxy for the SEE movements as well (though in not the same vicinity and with a time lag of course). The US real estate market already slowed down in recent months, after a period of post-pandemic boom. House prices peaked in mid-2022 (growing at cca. 15% on average in 2020 – mid-2022), showing stagnating or slightly decreasing mom rates during 2H2022 (data as of October-2022). US 30y mortgage rate has spiked in 2022, finishing the year at 6.7% (twice as higher compared to 3.3% at the end of 2021) which halt house prices in 2H2022. We see financial conditions limiting demand further, as rates are expected to continue rising. In December-2022 building permits for residential construction were cca. -30% yoy lower, following constantly negative trend in 2022, **indicating less construction activity in 2023 in the US – an important signal for global real estates**.

When it comes to the EU, house prices grew at a milder pace. Latest available data as of 3Q2022 illustrates house price growth slowing, while some countries are displaying qoq decrease (Germany, Italy and Sweden amongst major EU economies). Financial conditions are expected to halt additional price advances, as interest rates in Europe spiked reflecting on housing loan demand. Rates in EA on new lending for house purchases hit 2.9% in November-2022, adding 1.6 pp yoy. **We see a gap allowing house purchase interest rates to keep rising, expecting restrictive policy to continue in 2023**. Construction activity is still above previous year average, increasing 1.8% yoy in November-2022. **Construction sentiment (measured by PMI index) in EA has deteriorated in 2H2022 pointing to expected slowdown - PMI for construction sector dropped to 42.6 i.e. contraction area in January-2023 reaching back to its levels from the pandemic-impacted 2Q 2020.**

US 30y mortgage rate vis-à-vis FED rate
(%)



Interest rate for house purchase in EA vis-à-vis ECB policy rate
(%)



Source: FHFA, ECB and Bloomberg

Special topic – interest rates

We see monetary tightening and uncertainty surrounding 2023 being the main factors on the demand side in Adria region, hence this would also bring prices lower. Adria region is closely tied to the ECB monetary policy decisions. Slovenia and Croatia are part of single currency EA, while Bosnia and Herzegovina maintains currency board, moving interest rates in line with ECB. Serbia and North Macedonia have independent monetary policies, with inefficient transmission mechanisms, as bulk of their lending activity is issued in euros and linked to EURIBOR rates.

Housing loan interest rates in the region have been increasing in line with EURIBOR, even though there is some lag in the transmission largely connected to legislation i.e. application of changed interest rates according to legislative norms**.** Observing new business lending, Serbia and Slovenia saw the strongest jump in interest rate. In the rest of the region, we see lower interest rate movement, as banks may try to gauge as much loan demand possible and adapt their margins only gradually. All in all, restrictive monetary policy will continue to drive housing loan interest rates up at least though the 1H 2023. We also expect banks to tighten other lending standards as part of their standard risk management principles, likewise demotivating house purchase. Aside from that, uncertainty given 2023 economic dynamic will halt individual decisions to make major house purchases, also supporting our view for downward pressure on house prices. Back on interest rates, non-engaged ample liquidity in the banking system is mostly visible in Croatia and Bosnia and Herzegovina, which will also curb further rises in interest rates even as EURIBOR continues to rise – in other words, banks are reducing margins. Last but not least, faced with relatively high competition in the market, banks are more willing to offer better loan conditions in order to defend commission income.

As a result of the above elements, **we see interest rates on new EUR housing loans (including FX-linked) rising into the range of 5.0-6.5% on average in Adria region in 2023.** At the same time, regional Eurozone members are expected to deliver lower interest rates versus the rest of the region mostly due to lower risk premiums.

Average interest rates on new housing loans
(November-2022, %)

	interest rate	yoy change (pp)
HR	3.1	0.4
SI	3.4	1.9
RS	4.8	2.2
MK	3.4	0.1
BH	4.2	0.8
EURIBOR 6M	**2.3**	**2.9**

Source: National central banks
*rates on new housing loans in FX for RS, HR, MK and BH
**SI and BH: floating interest rates
***HR, RS and MK: fixed and floating interest rates

Outlook

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We see possible correction in building construction dynamic in most countries of the region, while also we see production factor challenges, mainly in the form of labour force shortages to limit construction activity in 2023. On the other hand, even though prices of building materials have dropped as of recently (many of them to pre-pandemic levels), they are still seen as a major constrain factor, given their relative unstable availability on the market. **Another factor to consider for Adria region construction activity is high base in the last two years**, which means that even a small reduction in construction activity should not be very much surprising. Infrastructure development, at the same time, is expected to withstand negative growth pressures, more so because of high level of financial support coming from EU – both in terms of cohesion funds for members and candidates or EBRD/EIB funding (for Serbia, Bosnia and Herzegovina and North Macedonia).

Regarding real estate, elevated demand is expected to calm down due to household income distortion caused by inflation and expected slowdown in Adria region economies. We see deteriorating financial conditions as main current demand pull – something that is already materialising in the major developed economies and the region's main trading partners, where 20% drop in new house starts is currently unfolding. In addition, perception of general economic uncertainty in 2023 will postpone house purchase decisions, providing relief to current demand, **ultimately in 2023 reducing the Adria region's house prices level by ca. 10% as compared to 2022 average.**

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