PLATFORM FOR DISCUSSION
Speaking note

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INVESTMENT AND FINANCE, CHALLENGES FOR THE CESEE REGION

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Investment and Finance, Challenges for the CESEE Region

1. Investment in CESEE – historical perspective and recent developments

The investment in spurring growth and supporting productivity and efficiency of an economy is a well-known principle. The larger the investments, the higher the potential to grow. Yet, the investment function is dependent on many factors such as expectations of investors, the already existing capital stock, the general business environment, the level of demand, technological progress, the possibility to invent and innovate, the leverage level, and the access to finance.

Before the outburst of the global crisis, investment was an important growth driver in the CESEE region, though the growth was not sufficient to provide for stronger capital accumulation. Notwithstanding the heterogeneity among countries, prior to the crisis, investment was an important contributor to the overall growth, supported by large capital inflows, which propelled the productivity of the economies, as well. The solid growth in general, including the inflows of foreign capital and rising investments, was a combined effect of the reform processes in these countries, and the extremely conducive global environment. Low interest rates, liquidity glut, expansion of global trade and global value chains were global features that supported investment growth in the region. Hence, the share of investment in GDP was rising prior to crisis (close to 10 p.p. in 2008 compared to 2000), reaching around 30% of GDP in 2008, well above the rule of thumb benchmark of 25%. Yet, according to the IMF (2016), given the easy pre-crisis funding conditions and low initial capital-labor ratio, "CESEE would have been expected to have much higher rates of capital accumulation than what they actually had". One reason for this might be that the financial flows fueled consumption as well, thus precluding stronger growth of saving and investment.

Chart 1: Share of investments in GDP, in % in constant terms)

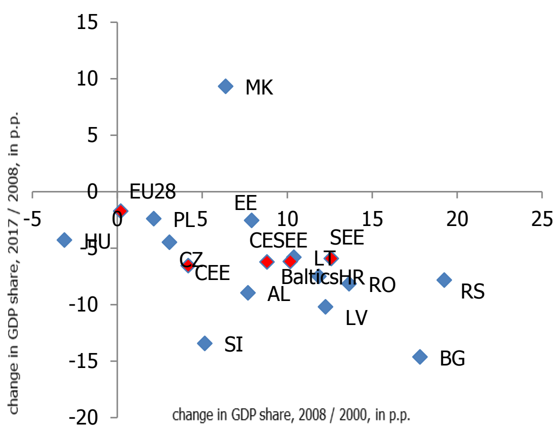
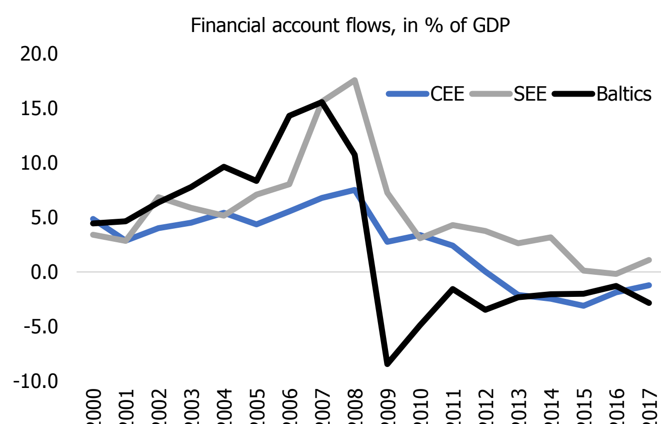


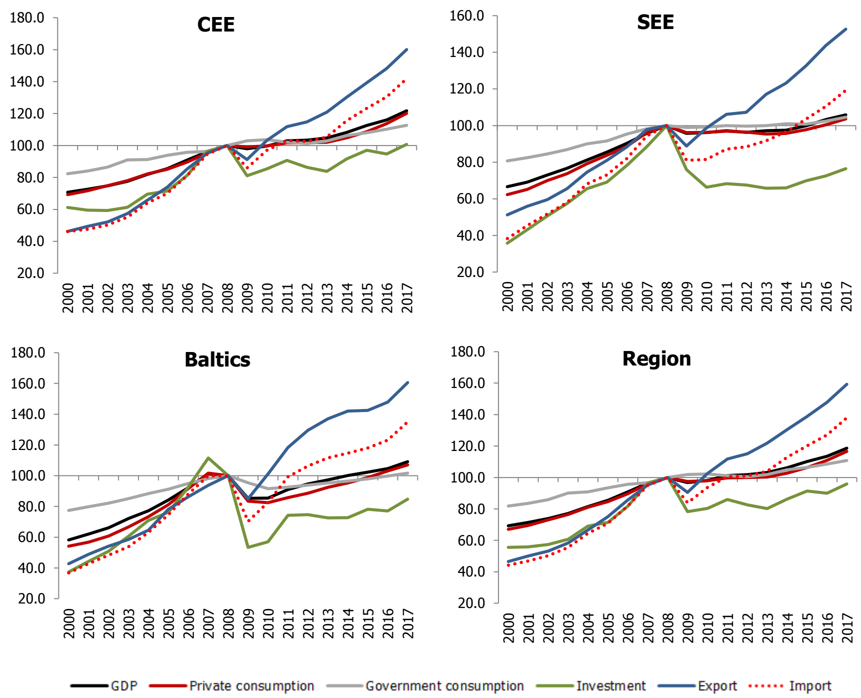
Chart 2. Capital flows, net in % of GDP



Source: Eurostat, IMF and NBRM calculations.

With the occurrence of the crisis, investment ratios plunged across the board, and despite the more recent recovery, the level of investment in most of the countries is still below the pre – crisis maximum. The crisis was accompanied by rising uncertainty, increased risk premium, and most importantly, sharp reversal in the external financing. The region has been shielded partially from the sudden stop, given the FDI dominance as a stable financing, and the contained bank deleveraging, amid regional initiatives (Vienna Initiative in particular). Yet, some of the countries were also caught by the crisis in the middle of rising vulnerabilities, excessive leverage in particular, which precluded faster recovery of the investment rates. The level of investment, ten years after the emergence of the crisis, is below the pre-crisis maximum in the EU as a whole, and in the CESEE region as well. Exception is countries such as Macedonia, Poland, and Estonia recently, where investment pattern was different, and the current level is above the pre-crisis one.

Chart 3: GDP and demand components, 2008=100



Source: Eurostat and NBRM calculations.

At the current juncture, an important question is whether such slow post-crisis investment recovery should be perceived as a natural cyclical adjustment, or are there some structural forces that also play role? Investment spending, in theory and in practice, is highly pro-cyclical and more volatile than GDP. In general, this holds for the CESEE region, as well. Therefore, there is no doubt that significant part of the observed slowdown in investment demand in the CESEE region after the crisis is cyclical in nature. In addition, simple analysis of relative volatility of investment points out to a decline in volatility of investment in the period after the crisis, which could be an indication of an unsustainable investment boom in CESEE region before the crisis.

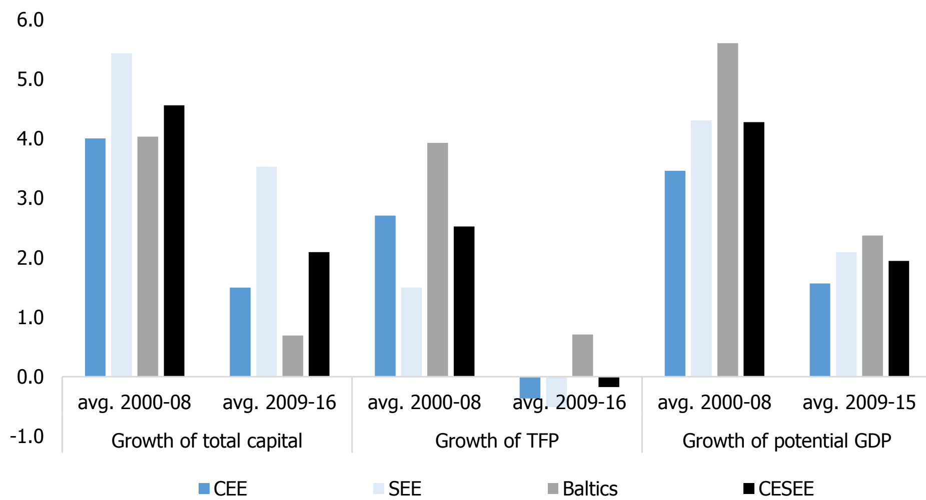
Table 1: Pro-cyclicality and relative volatility of investment

	Correlation between y-o-y change in investment and GDP		Volatility of investment relative to GDP*		Volatility of investment in CESEEE relative to EU28**	
	2001-2008	2009-2017	2001-2008	2009-2017	2001-2008	2009-2017
CESEE	0.93	0.93	5.20	3.99	2.02	1.29
EU28	0.89	0.98	3.38	3.31		

*std.deviation of the y-o-y change in investment relative to std.deviation of the y-o-y change in GDP
*std.deviation of the y-o-y change in investment in CESEE relative to std.deviation of the y-o-y change in investment in EU28
Source: Eurostat and NBRM calculations.

Nevertheless, the observed slowdown in investment activity is persistent which might have negative impact on growth potential of CESEE region. Investment flows define capital dynamics by renewing and augmenting capital stock, which in turn is one of the determinants of potential growth. Lower investment also implies faster depreciation and lower maintenance of capital stock. For the CESEE region, data shows significantly smaller capital growth in the post-crisis period (the only exception is Macedonia[1]). Though the decline/significantly depressed growth in TFP is the key factor for the observed slowdown in potential growth across the region, slower capital accumulation also played a role.

Chart 4: Capital, TFP and potential GDP before and after the crisis (average growth rates across countries, in %)



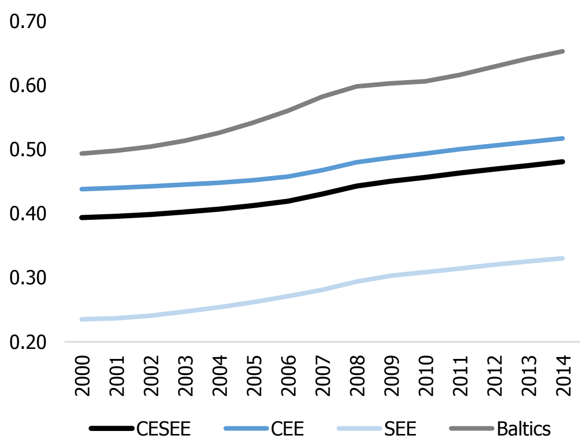
Source: World Bank, The Conference Board Total Economy Database and NBRM calculations.

Apparently, the region is in need to boost investment growth, catch-up with the pre-crisis level, and narrow some of the existing gaps. As, not only has investment been lower compared to the pre-crisis period, but also some of the international institutions assess their level to be below estimated benchmarks, which are consistent with the features and the development level of the region. For instance, EBRD in its Transition Report (2015-2016)[2] provides estimates for the investment shortfalls in some of the countries in the region. The estimates are perceived as conservative, as they do not reveal the needed investment level. They rather reflect the investment level consistent with the one pertinent to comparable countries. The estimates reveal shortfall, meaning that after the crisis, the investment in the

[1] The only exception is Macedonia, given the strong investment cycle after the crisis, driven by public investments and structural reforms in the export segment.
[2] Transition report 2015-2016 "Rebalancing Finance", European Bank for reconstruction and development.

region is lower than in the peer countries, in the range of around 3 to 6 percentage points of GDP. Similar inference is drawn by the IMF (2016)[3], pinpointing post-crisis gaps in the capital stock in the CESEE region compared to estimated benchmarks, being reflection of lower savings rates in the region, narrower borrowing space after the crisis and lower return on investment. This notion is confirmed with the data on the real capital stock in the region, as well, which is around 40% of the EU-28 average, with the SEE region lagging behind significantly. Though this ratio is rising, yet it clearly indicates large scope for improvement.

Chart 5: Real capital stock, per capita in CESEE region vis-à-vis EU28



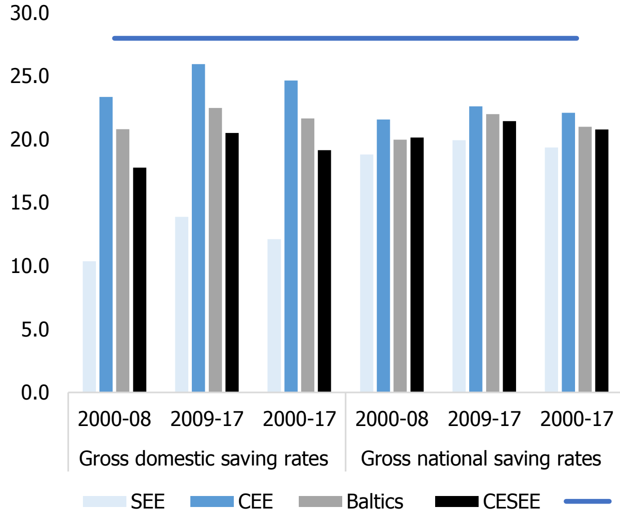
Source: Penn World Table, version 9.0 and NBRM calculations

2. Investment financing

Many policy measures for unleashing investment growth are suggested in this context. Boosting saving rates of the corporate sector in the region by enhancing incentives for reinvesting earnings, rather than distributing dividends, supporting household savings by putting stronger emphasis on Pilar II and III pension schemes. **Enhancing productivity and hence return on investment** has been heavily debated issue for the region for many years, as well. Many structural and institutional bottlenecks in the region have been frequently pinpointed as hurdles for higher productivity and investment. Those are institutions, governance, human capital, innovation**, with the access to financing being mentioned as an important constraint, as well**.

[3] Central, Eastern, and Southeastern Europe - How to Get Back on the Fast Track?, Regional Economic Issues May 2016, International Monetary Fund.

Chart 6: National and domestic saving rates, averages for 2000-2017 period (% of GDP)

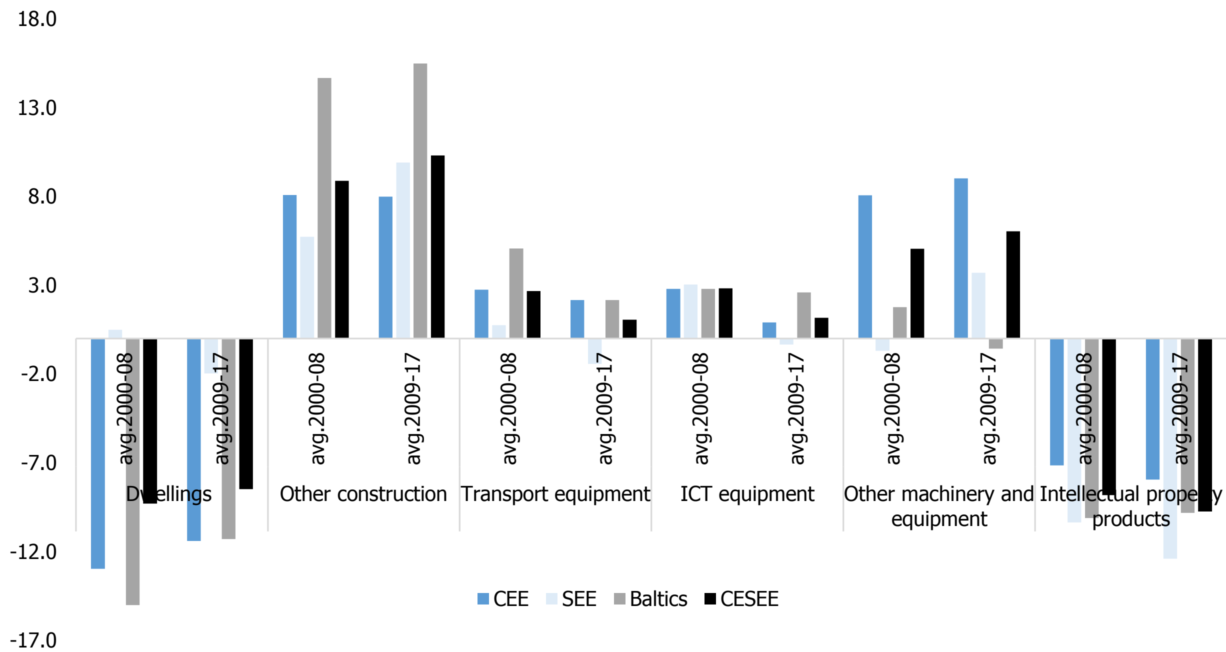


Source: Eurostat and NBRM calculations

When it comes to financing, a matter that we focus on more closely further in the note, important issues come to fore. First, what are the main segments where large investment needs are in place, thus requiring priority in allocating finance and alleviating access to it? To tackle this question we will discuss more thoroughly the investment structure. The **second** matter of interest is how to reconcile the current large investment needs of the region, with the already high leverage level, both in the private and public sector, as well. This will be also discussed further in the note.

Structural decomposition of investment in CESEE countries vis-à-vis EU points to CESEE countries having larger share of investment in non-residential construction, and, to a lesser extent, in machinery, transport equipment and ICT equipment. This structural characteristic is connected with two historical episodes – first, the transition process, when large investment was needed to replace and renew the outdated infrastructure and second, large capital inflows in the form of FDI before the crisis triggered increase in the imports of machinery and equipment goods. On the other hand, **CESEE region faces potential weaknesses in the part of investment activity connected with intellectual property, innovation and R&D.** Namely, in all CESEE countries, there is a gap in investment in intellectual property, which, in turn creates critical support for more dynamic increase in productivity and value added, boost economic growth and real convergence. For the whole region, the gap vis-à-vis EU is around 9 p.p., for the period 2000-2008, and 10 p.p, for the period 2009-2017, but for some countries it is even larger (e.g. for Albania the difference is around 17 p.p. in the share of intellectual property vis-à-vis the EU share).

Chart 7: Investment categories, difference vis-à-vis the EU in the share of the respective category in total investment (p.p.)



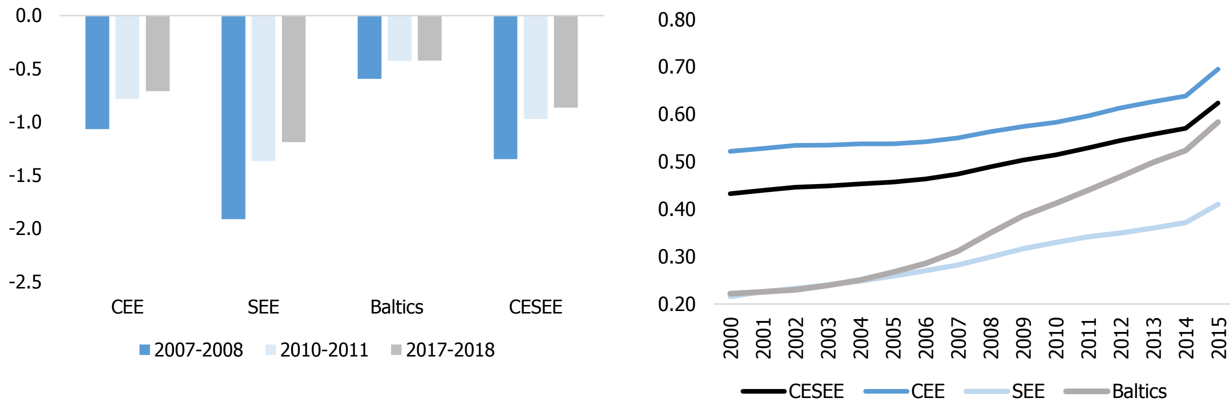
Source: Eurostat and NBRM calculations.

Another important aspect in the investment-growth nexus is the infrastructure quality and spending on infrastructure. Do CESEE countries spend enough on infrastructure? World economic forum indicators show infrastructure quality gap between CESEE region and EU-28 in the period 2017-2018 - the quality of infrastructure in the CESEE region, is around 4.3 on average, whereas the same index for the EU-28 is 5.1[4]. The picture is very similar if one looks at the data on stock of public capital, which reflects to a large extent the availability of infrastructure – stock of public infrastructure in CESEE countries in 2015 is around 60% compared to EU-28 stock. According to both indicators, SEE region has largest infrastructure gaps in the group. EBRD[5] concludes that current spending on infrastructure in CESEE region "are low by historical standard" and that "infrastructure spending needs to rise by at least half a percentage point of GDP, unless significant improvements can be made in terms of the cost-efficiency of infrastructure spending".

[4] NBRM calculations based on World Economic Forum estimates (2017-2018 edition).
[5] Transition report 2015-2016 "Rebalancing Finance", European Bank for reconstruction and development.

Chart 8: Quality of infrastructure in CESEE region vis-à-vis EU 28

Quality of infrastructure index (difference in p.p.) Real public capital stock, per capita, % of EU-28



Source: World Economic Forum, IMF Investment and Capital Stock Dataset (2017) and NBRM calculations.

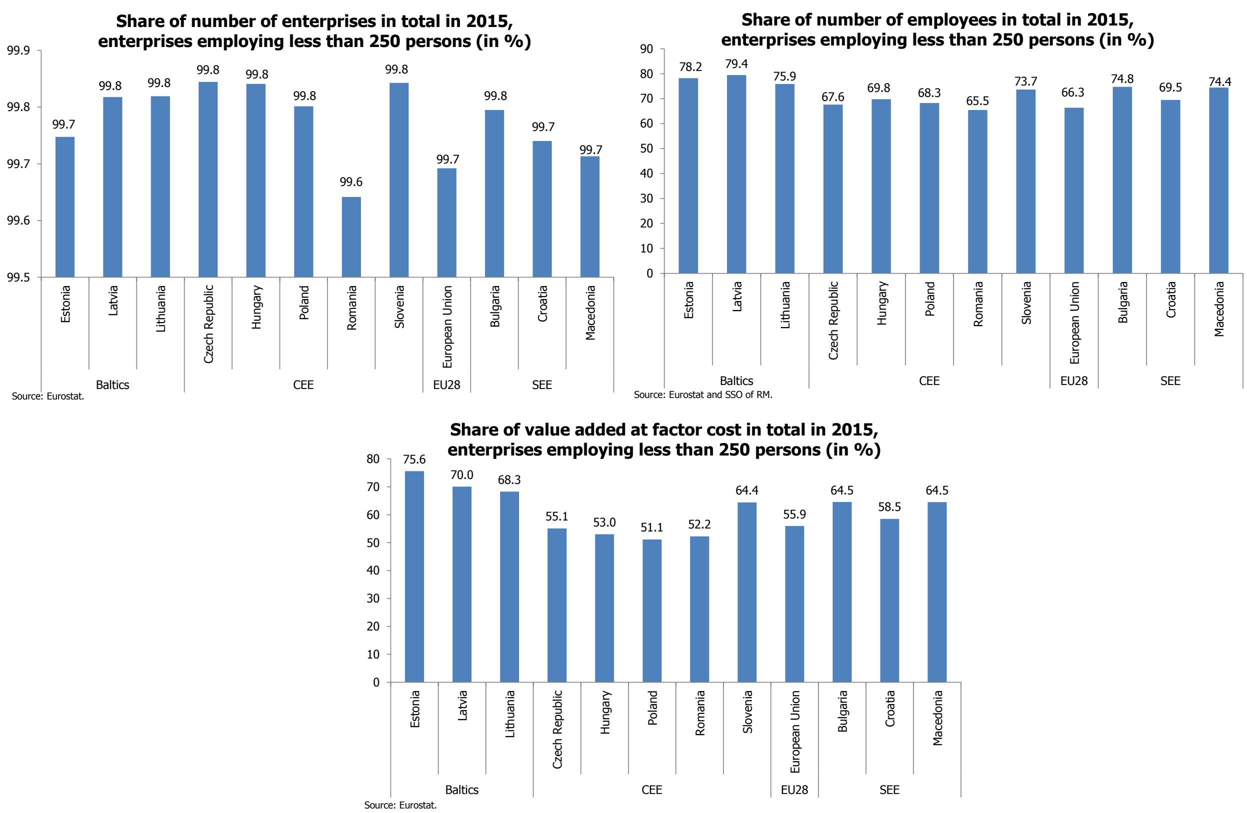
Complementary and equally important question is whether CESEE countries invest in cost-effective, viable and long-term growth supportive projects. Largest part of infrastructure projects in CESEE region is publicly financed (60-70% in transition countries, compared with 15 to 60% in the EU-15 economies[6]). This is problematic because of two reasons – first, public resources may become insufficient for infrastructure financing, given the tight fiscal constraints and rising public debts and second, in practice, very often, public investment decisions are not guided by economic rationale which might lead to inefficient and unproductive projects. Improvements in fiscal institutions, fiscal rules, **public-private partnership, foreign financing partly in the form of grants**, improvements in public investment management frameworks are some of the possible "remedies" that might generate improvements in the infrastructure in the CESEE region.

3. SMEs' investment activity and access to finance

Apart from the needs for investment in infrastructure, as mentioned above, apparently what the region is also in need of are the investments in more technologically advanced and innovative segments, investments that are very often led by SMEs, or start-up companies. In order to grow and to be economically productive, this sector needs stable sources of financing. Without access to finance SMEs are unable to invest, which impairs their capacity to improve productivity, raise competitiveness, promote innovation, generate employment, and contribute to economic growth and development. And the importance of the SMEs sector is continually increasing. According to some studies, majority of enterprises globally are SMEs, accounting for approximately more than a half of private sector employment. In fact, the latest data on SMEs in the EU, as well as some of the countries in the region, confirm the importance of this sector in terms of the number of companies, its share in the total value added, as well as in the total employment.

[6] Transition report 2015-2016 "Rebalancing Finance", European Bank for reconstruction and development.

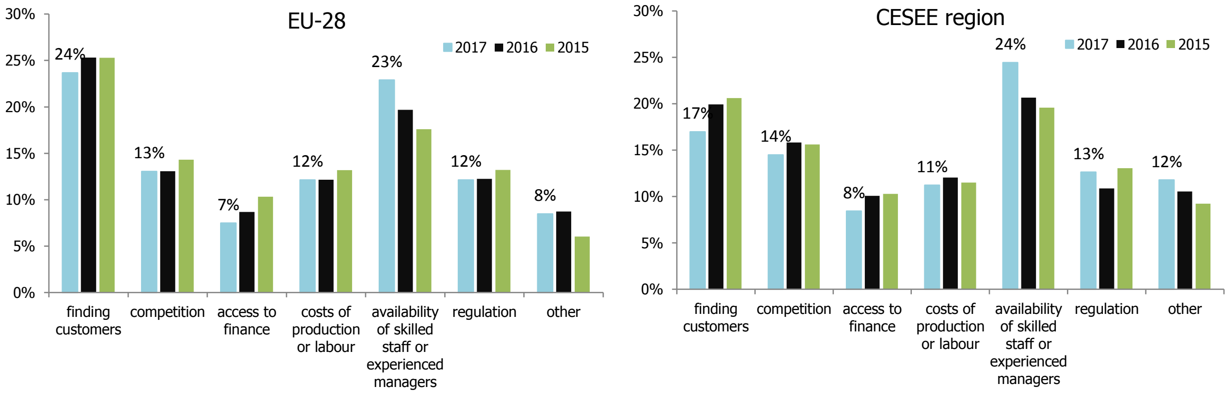
Chart 9: The importance of SMEs



To depict more closely the state of the SMEs and the own perception of their business environment, in the next section we will focus on the results of the Survey on the Access to Finance of Enterprises (SAFE survey of the EC and the ECB). The Survey itself pinpoints the concentration of SMEs in trade and services (around 70% on average, both for the EU and the region), with many of the companies not having export of goods and services in their total turnover (around half of surveyed companies). The survey data also indicate that SMEs from the EU and the region face rather similar challenges in terms of the main perceived obstacles in doing their business. Finding customers and availability of skilled labor seem to be the main issues of the SMEs from the European Union and from the region. Thus, 7-8% of the companies perceives access to financing as the most important current problem, but there are countries, Macedonia in particular, where this percentage is higher (13%), and with a similar weight compared to most of the other obstacles[7].

[7] Survey on the access to finance of enterprises (SAFE), September to October 2017

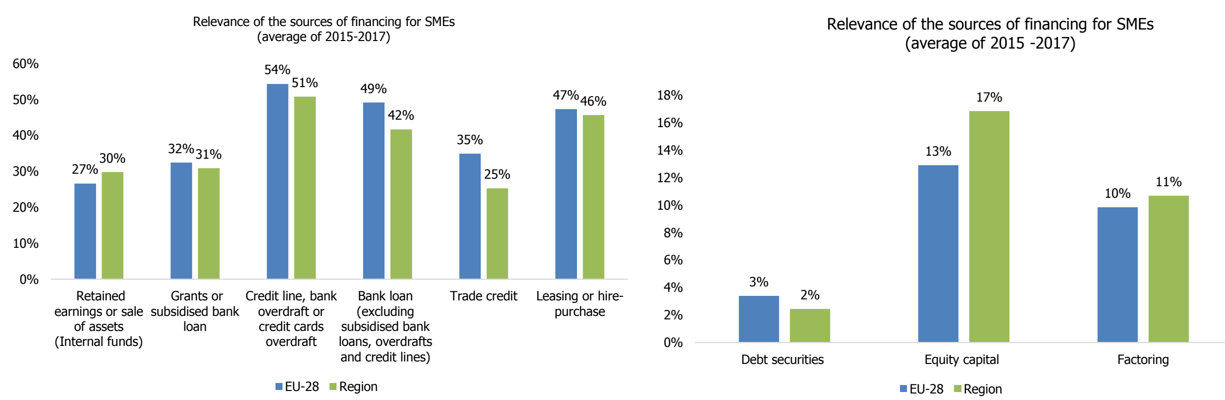
Chart 10: The most important problems that the SMEs are currently facing with
(Average 2015-2017, % of the total number of surveyed companies)



Source: Survey on the access to finance of enterprises (SAFE), EC and ECB.

Despite the fact that according to the Survey, access to finance itself is not the major impediment for the SMEs, it is still an important caveat. And going under the surface and dissecting the sources of financing, one can note important structural features*.* **First,** bank-related products remained the most relevant source of financing for SMEs compared with market-based instruments. The SMEs from the European Union and from the region do not differ much in terms of the main sources of financing. Around half of the European SMEs and from the region agree that the most relevant source for financing are the bank related products (credit line, bank overdraft, bank loans) and leasing or hire purchase. Also, companies from the region and the European Union use grants or subsidized bank loans and retained earnings (one third of the companies) as source for financing. On the other hand, market-based instruments, such as equity and debt securities, and factoring are less considered potential source of financing.

Chart 11: Relevance of different sources of financing

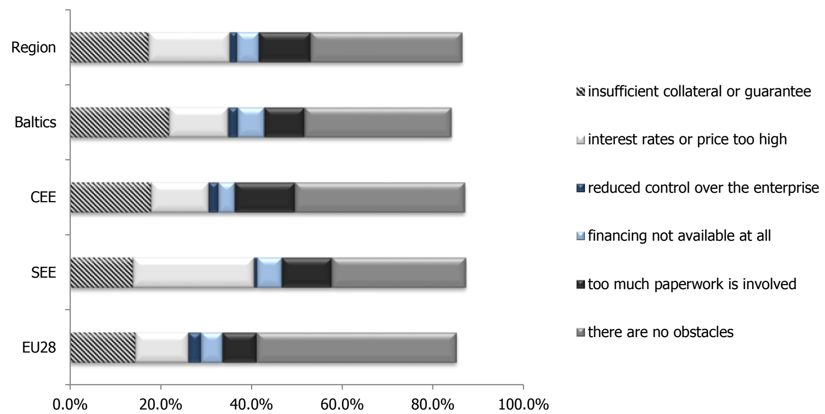


Source: Survey on the access to finance of enterprises (SAFE), EC and ECB.

Second, for those companies that external finance seems to be important caveat, the main causes are related to the inadequate collateral, high costs and complex procedures. Both notions bring to the fore the need to discuss the state of play and the potential for financing with alternative instruments through capital markets.

Chart 12: The most important limiting factors for external financing

(Average 2015-2017, % of the total number of surveyed companies)



Source: Survey on the access to finance of enterprises (SAFE), EC and ECB.

4. Capital markets in CESEE – potential source for finance

Although greatly used, the traditional sources of finance, such as government financing for infrastructure, or financing through domestic banks of SMEs might be either limited in size, or constrained by some structural impediments. Hence, these sources might not be sufficient to close financing gaps. **In this context, capital markets can have significant role for bridging the existing gaps. Benefits of developed capital markets are well known**. They could complement banks as a source of financing and could: 1) unlock more investment for all companies, especially SMEs and for infrastructure projects, 2) attract more investment to the region through external financing, and 3) make the financial system more stable and resilient by opening up a wide range of funding sources[8]. Thus, capital markets have potential to foster growth.

Despite the continuous progress, capital markets in the CESEE region still lag behind the more advanced EU countries. In most of the countries in the region, the financial system is bank-based. Capital markets in CESEE countries have expanded significantly, since they were originally created[9]. Despite the growth from the low base, and given the impact of the global crisis on the market growth momentum, the capital market depth (listed shares and bonds) in the region is hovering around 50% of GDP, far below the EU average for 2008-2016 of around 200% of GDP. Similar is the assessment of the region on the financial market development in the Global Competitiveness Report. The region is positioned in the middle of the scored countries, and the SEE region has the poorest ranking. While some of the reasons for the low capital market development might be linked to demand factors (dominance of

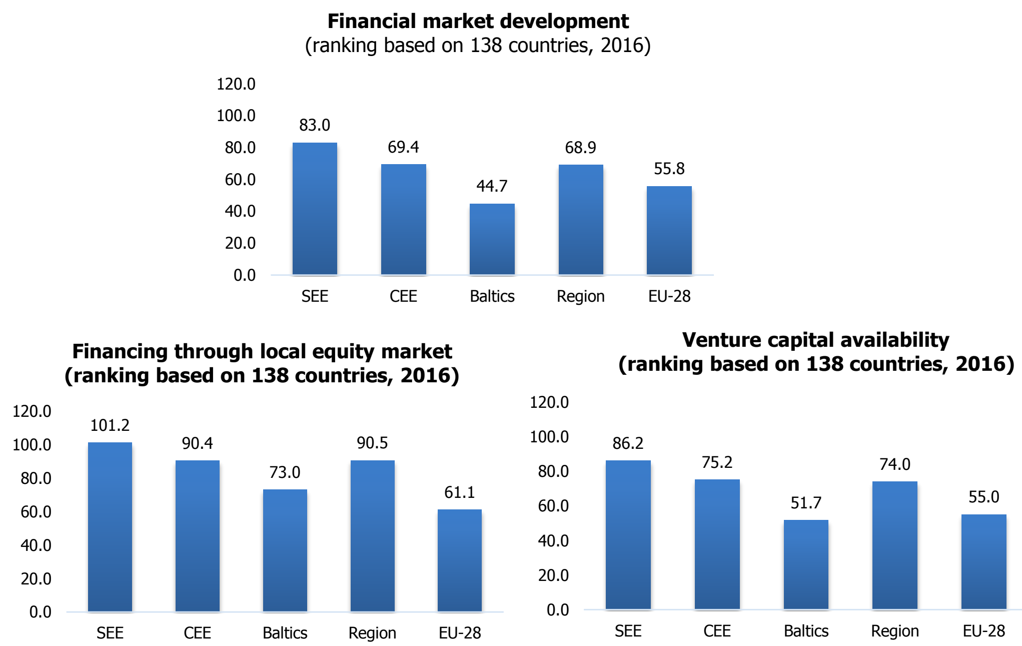
[8] EU Green paper on capital markets, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0063&from=EN.

[9] Stock exchanges were established at different points in the transition process: Bulgaria, Hungary, Poland, Russia and Slovenia opened their stock markets in 1990–91; the Czech Republic, Lithuania and the Slovak Republic followed in 1993; Latvia and Romania were next in 1995, followed by Estonia in 1996. Turkey's stock exchange was established much earlier than those of the transition countries, in early-1986.

SMEs that are more prone to bank credits), some of the causes are related to supply-side factors. And when discussing the latter group of reasons, commonly four important aspects are highlighted: 1) the role of equity; 2) the role of institutional investors; 3) household preference for bank deposits and 4) regulatory environment.

When it comes to equity, a large distance compared to the EU-28 average is visible in the area of financing through local equity market and venture capital availability, with a rank of 90 and 74 (EU-28 average rank is 61 and 55). Yet, concerning the availability of venture capital, some CESEE countries (the Baltics, Czech Republic, Slovakia, Bulgaria, Macedonia) score rather well, reflecting the public support and a favorable regulatory environment. "This is encouraging given the importance of this financing channel for start-ups and innovative companies".

Chart 13: Financial market development, ranking based on the Global Competiveness Report



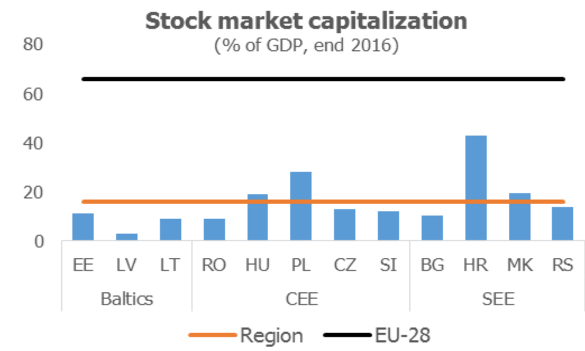
Source: World Economic Forum.

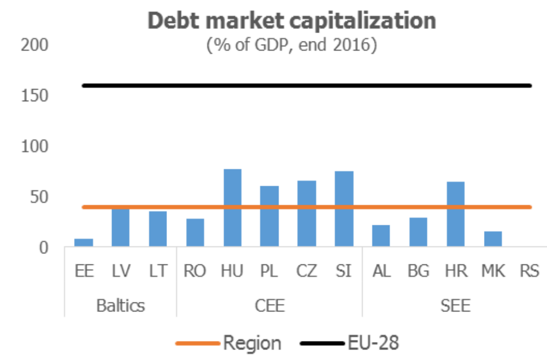
Equity markets in the region are quite shallow, with a stock market capitalization averaging around 15% of GDP, compared to the EU-28 average of close to 70% in 2016. Positive outliers in this context are countries such as Croatia (43% of GDP) or Poland (close to 30% of GDP). Similar is the inference when it comes to private equity, which is considered an attractive source of financing for young firms, or companies not listed on the stock exchange. It is a model that enables risk-sharing, and fosters management and operational efficiency. The main role of private equity is to fill the gap between internally generated financing and conventional market sources, such as bank loans and public equity. Unlike most stock market investments, equity investment enables shareholders to adopt a long-term and hands-on approach in their investee companies, fostering sound corporate governance and transparency, making appropriate contributions to business strategy and optimizing management. Crucially, however, it also contributes to the transfer of skills and has positive demonstration effects in terms of the development of local capital markets and competitive market-oriented behavior[10]. These modalities such

[10] EBRD Transition report 2015-2016.

as, venture capital, crowdfunding, business angels, are relatively modest in the CESEE, although the same holds for the EU as well, where private equity has a share of around 0.3% in GDP. Debt market in the region is larger compared to the equity, averaging around 50% of GDP, which is still much lower compared to the EU-28 average of close to 160%. Yet, dominant part of this market segment is related to government securities, while the corporate issuance remains modest. In fact, in most CESEE countries, corporate bond markets remain small, or even nonexistent.

Chart 14: Stock and debt market capitalization

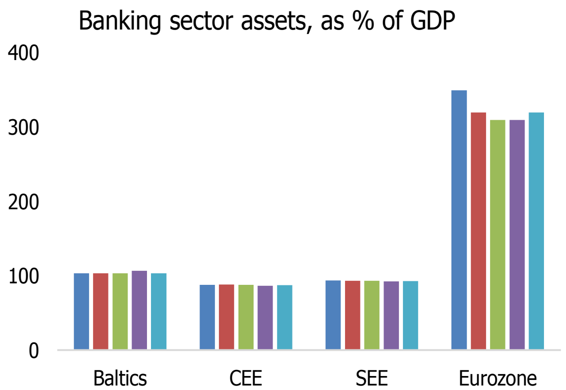


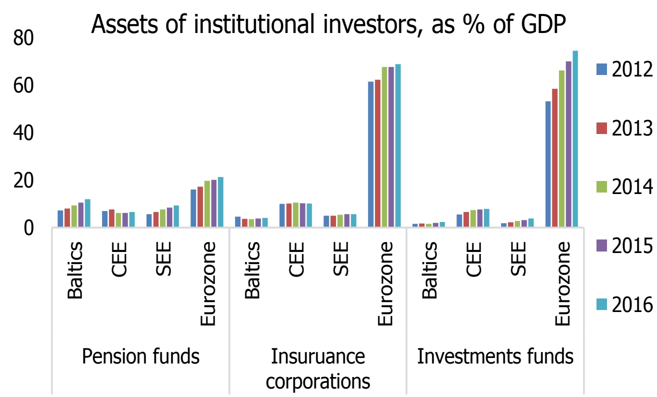


Source: ECB and central bank websites.

To recap, the region needs to mobilize finance, which amidst burdened government financing and structurally difficult access to bank finance for new and innovative companies, requires further development of the capital markets and more diversified portfolio of financial instruments. **One of the key questions going forward is where the potential for financing might come from. The potential of capital markets is usually determined by the domestic institutional investor base.** Traditional institutional investors (pension funds, investment funds and insurance companies) are present in all CESEE countries, but mostly in the government bond-market segment. However, their role in the CESEE region is smaller, compared to the EU as a whole, and there is a lot of variation across countries. For instance, assets of insurance undertakings and pensions, as a share of GDP, stood roughly at 33% in Croatia, compared to 6% in Romania.

Chart 15: Banking sector assets and assets of institutional investors (pension funds, insurance corporations and investment funds) in CESEE countries, as % of GDP

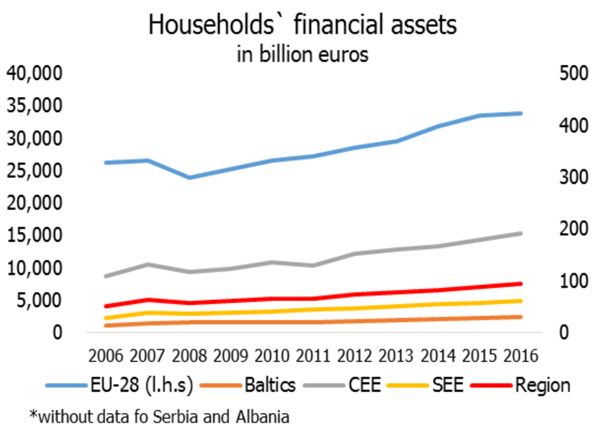


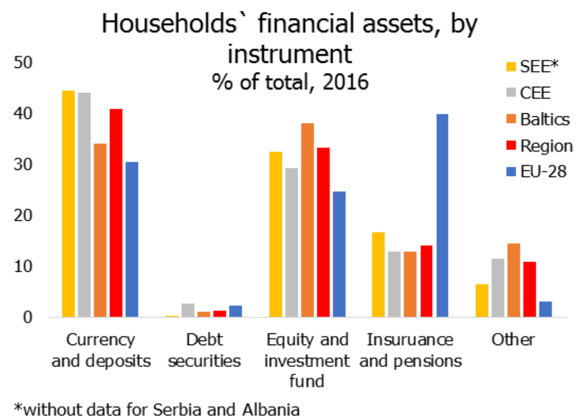


Source: ECB, OECD statistics.

Another aspect linked to the potential of institutional investors and relevant in the context of capital markets development are household saving preferences. Large part of financial wealth of households in CESEE countries is invested in bank deposits. This is especially the case of Macedonia and Croatia (with 55% and 62% of total financial assets, respectively) with most CESEE countries staying above the EU average (30%). Subsequently, equity, insurance and pension investments are below the EU average. There are some notable exceptions (Estonia, Bulgaria, Hungary and Lithuania) with share of equity and investment fund shares in total financial assets of 52%, 42%%, 40% and 40% respectively. Broadening the financial knowledge of households and raising their awareness of the possible investment alternatives, might provide support to institutional investors.

Chart 16: Households` financial assets





Source: Eurostat

Even if the potential of institutional investors is large or underutilized, allocating their funds to cover the financing gaps requires tailored-made financial instruments. "These groups of investors are more likely to be interested in investments in fixed income instruments, given their potential to deliver long stable cash flows with attractive yields, but potentially with less volatility than equity options". Instruments that can be used for this purpose are: 1) corporate bonds issuance (by SMEs and SME lenders), 2) securitization structures (project bonds on infrastructure side and loan securitization on the SME side), 3) covered bonds (mainly for SMEs financing), and 4) debt funds (for infrastructure and SME related assets). Given the low level of development of capital market structures in CESEE countries, connecting SMEs financing needs with the funds of bank and non-bank investors via securitization of SMEs loan seems to be viable solution, thus assisting banks in their ability to fund and distribute a risk. Although in some of the countries banks do not face funding problems, SME securitization allows for transformation of SMEs loans that have low liquidity into tradable securities. This creates secondary market, for SMEs loans, but also contributes to the general market development.

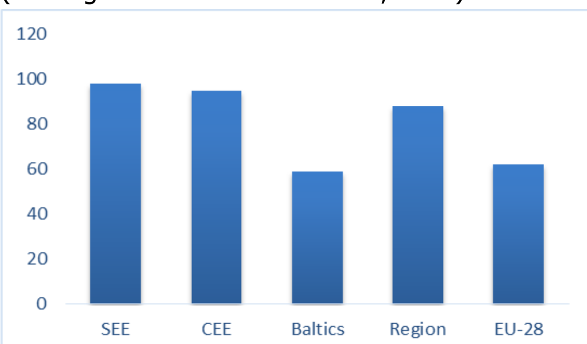
The need for deeper and more developed capital markets, to complement traditional sources of financing and support investment and innovation is common feature for the region. Yet many country specifics are in place, and this makes proposing "one-fit all" solutions very difficult. Following the findings of the Vienna initiative group on capital market development[11], and the way the obstacles and solutions are schematized, several conclusions can be drawn.

[11] Report by the Working Group on Capital Markets Union, March 2018.

First, CESEE countries must develop comprehensive policies and strategies aimed at addressing the financing gap in infrastructure and SMEs financing. Strategies should include a clear assessment of the role that capital markets in general and institutional investors in particular can have, along with the measures necessary to use the potential. In practice, challenges of mobilization institutional investors to infrastructure and SMEs financing are complex, and addressing them requires participation of many public entities in coordination with the public sector.

Second, conducive regulatory environment is an important prerequisite for the development of capital markets. The perception of the level of investors` protection and the degree to which the markets are fair and transparent are the key factors that investors take into consideration when investing in jurisdiction. That is why a stronger regulatory and supervisory environment, including better protection of property rights, creditor rights and information, have all been shown to be positively associated with higher level of financial development. In this respect, despite the wide country variation, most of CESEE countries are ranked below EU-28 average.

Chart 17: Regulation of securities exchanges (ranking based on 138 countries, 2016)*



Third, regional cooperation regarding market infrastructure can boost capital market development. Significant efforts have been made to linkup the national exchanges and harmonize legislation and regulation across the entire region, without requiring any country to give up their national stock exchanges or their rights to regulate their home markets. The so-called "passporting" framework has been put in place that allows for issuers, investors and market intermediaries to operate in each other's national market, thereby creating a vastly larger 'common' market, without sacrificing any institutions or independence. The cooperation of stock exchanges in Baltic countries is most advanced. As part of Nasdaq OMX group, these countries form the Baltic market[12]. Further authorities` efforts in CESEE countries should address several issues: 1) strengthening existing regional alliances of stock exchanges (Nasdaq Baltic Market, CEESEG, SEE Link), 2) foreign listing and market access, 3) Central Securities Depositories –options for regional connection, 4) Central Clearing Counterparties for cross border settlements, 5) Creating regional markets through alignment of national legislations.

Fourth, the role of international financial institutions should also be highlighted. In the last decades, many IFIs have provided immense support to the region as a whole, through finance, technical assistance and expertise. For the specific issues discussed, apparently pure finance is not sufficient. The

[12] Nasdaq Baltic Market is the common equities market with harmonized trading rules and market practices, single trading system, joint trading lists, harmonized indexes, single membership and single trading and settlement currency, allowing investors easy access to all Baltic listed financial instruments through any of the exchanges.

so called “blended” funding, which combines provision of credit, grants, expertise and advice, at the same time, probably is the optimal support for sustained development.

5. Conclusion

Investment was an important growth driver in the CESEE region before the outburst of the global crisis. However, after the crisis, investment ratios plunged across the board with the level of investment in most of the countries still below the pre-crisis maximum. The slow post crisis recovery is rather persistent and might have serious negative effects on the potential for growth of the region.

One of the frequently underlined constraints for more rapid investment growth in CESEE region, among others, is the access to financing. Along this line, an important aspect is how to reconcile the current large investment needs in the region with the already high leverage level, both in the public and in the private sector.

Public sector investment is usually concentrated on the infrastructure segment, an area where CESEE region has achieved substantial progress in the last two decades. However, indicators still pinpoint to existence of significant gaps compared to EU-28 in this area. Improvements in fiscal institutions, fiscal rules, public-private partnership, foreign financing partly in form of grants, improvements in public investment management frameworks are some of the possible "remedies" that might generate improvements in the infrastructure in the CESEE region.

When it comes to the private sector, the focus has been put on innovative companies, which can fill the gaps in more sophisticated investments that can elevate the potential growth of the economies. Given the more limited access to banking finance for this corporate segment, alternative sources of financing are being explored, which requires concerted policy and private sector action in further and stronger development of financial markets and mobilizing available finance in a more efficient way.

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