CEE region financing and investment gap

Peter Paluš

Head of the Financial Unit, Permanent Representation of the Slovak Republic to EU

Need to route investments towards new trends for economic development

Looking to the coming future, fourth Industrial revolution will shape economy landscape and our daily lives. Beside opportunities it brings along threats if we are caught vulnerable. Therefore, we need to prepare and think carefully about stack of investment policies which would mitigate weaknesses and fully exploit favourable circumstances.

Immense challenge emerges from the backbone of Slovak economy, particularly our historically strong automotive industry. Ignoring ongoing transformation from traditional car industry and fossil fuels to eVehicles and sustainable energy sources may endanger vast labor force – according the OECD 40% of jobs are in Slovakia at risk of automatisation while e.g. only 4% in Norway – thus, investments to innovation, R&D, digital infrastructure, energy efficiency and education are necessary.

Having proper access to – supply side – finance is one prerequisite to succeed. EU cohesion funds, European Fund for Strategic Investments, the EIB and national promotional bank provide enough resources to fulfil reforms. However, we identified bottlenecks on demand side – lack of high-quality projects and know-how which match current needs.

What can policy makers do to unlock full potential of financing and keep up with recent development trends? One does not need to start from scratch, Commission's country report caters solid proposals:

- increase attractiveness, efficiency and competitiveness of the research and innovation system;
- attracting and retaining qualified researchers in the smart specialization areas;
- increase cooperation between the business and academia;
- mobilizing knowledge and technology transfer;
- support companies to move up in global value chains;
- increase productivity facilitating participation in industry led and research driven international clusters;
- training and reskilling for smart specialization areas at all levels;
- improve energy efficiency in public and residential buildings and small and medium sized enterprises.

We should react promptly, change is at horizon otherwise we might find ourselves in productivity trap with high social costs. ●

Debora Revoltella

Director Economic Department,
European Investment Bank (EIB)

Addressing the financing and investment gap in CESEE

Most CESEE countries are modest or moderate innovators (EC classification), even if there is substantial heterogeneity in the evolution of innovation performance across countries and some hot spots of innovation hubs. Low innovation performance is associated to relatively low investment in intangible assets that remains very dependent on European Structural and Investment Funds and foreign R&D investors, skills shortages, a low smart-digital penetration and an operating environment that prevents scaling up of technological advancement.

As a result, a stronger role for innovation to increase productivity is a key element of the new growth model for CESEE, to escape a middle-income trap. To this end, stronger investment, skill development and a system of financial intermediation that supports investment and innovation are crucial.

Launched 10 years ago, the Vienna Initiative is a private-public coordination platform to address macro-financial issues in the CESEE region. In this context, two new working groups have been looking at markets gaps and priority policy areas for investment and innovation in the CESEE region. The working groups have looked at the role of private and public sector, as well as the shaping of IFIs intervention for the purpose.

> *"IFIs have been playing an important role in supporting access to finance of the private sector in CESEE."*
>
> \- DEBORA REVOLTELLA

In the context of the new Multi Annual Financial Framework, the recommendations from those working groups aim to provide a contribution to shape the next generation of IFI products, leveraging on the financial instruments concept, assessing the needs and characteristics of the local investor base and strengthening the cooperation among IFIs.

IFIs have been playing an important role in supporting access to finance of the private sector in CESEE. Looking ahead, IFIs can continue to play a catalytic role in the transition of the region's economies towards a new growth model, based on productivity growth through human capital development and home-grown innovation. A proper tailoring of IFIs product in this direction is crucial.

The new reports identify the key policy priorities for action in this context:

1. To support lending to SMEs and MidCaps, capital relief products are at the moment more in need than liquidity. Impact Finance Products covering first loss risks (e.g. COSME, PF4EE, SME-Initiative, etc) or pre-bankable finance (e.g. EDP, IDFF, Future Mobility) are particularly relevant.

>>>

2. Compliance with the minimum requirement for own funds and eligible liabilities (MREL) targets will pose challenges for the banks operating in the region in the coming years.
3. Due to a shift in demand towards local currency products, IFIs should consider further broadening their domestic currency-denominated product palette.
4. EU-funded venture capital programmes boosted the entire VC ecosystem and start up world in the region. Similar initiatives in the future would bring further benefits by focusing increasingly on qualitative results.
5. Venture Debt (VD) is a product offered by banks and specialised funds as a complementary source of later stage risk financing, alongside existing VC funding or equity solutions. The Venture Debt market is relatively underdeveloped in Europe and in nascent stage in CESEE region. There is further potential to develop commercial banks' offering of Venture Debt, with the support of IFIs.
6. IFIs could provide a more targeted financing option for the corporates of the region by adapting their product offers to the specificities of CESEE, potentially by providing smaller ticket sizes, more flexibility in the loan structures, quicker decision-making etc.
7. Using grants in combination with financial instruments is an efficient way to support investments with high socio-economic impact, and such combinations have a high potential for use in CESEE.

The framework for financial instruments proposed by the EC for the next MFF (InvestEU) addresses a number of issues. It is important that the fruitful regular dialogue between the private and public sector parties continue, to maximise the benefits and impact of financial instruments in the market. Better and more accessible data on IFI product supply could help to maximise overall impact and could promote better coordination among IFIs. ●

Contributor: Aron Gereben, Senior Economist, European Investment Bank (EIB)

Benjamin Angel

Director, Economic and Financial Affairs, European Commission

Re-igniting investment in CEEs

Investment remains at the top of the policy agenda in Europe. EU funding, both grants and financial instruments, is providing a significant contribution to public investment in the CEEs, helping to mobilise private investment, strengthening national, and local authorities, and civil society.

What is the magnitude of the financing and investment gap in the CEE region?

Investment in the CEE region has been above the EU average, fluctuating around 20 - 25% of GDP with humps in the late 1990s and before the crisis. Still, some factors suggest a significant investment gap.

First, the capital endowment of CEE economies remains well below the EU average. Hence, as these countries converge to their economically more advanced peers, a prolonged period of higher investment to GDP ratios appears necessary.

Second, the investment ratio is still below the pre-crisis level in a number of countries. The part of crisis-induced fall in investment may have been structural, with implications for the capital stock and potential growth. The crisis brought rising uncertainty, increased risk premia and a reversal in external funding, which have not fully recovered.

"Three most important challenges facing the CEE countries."

\- BENJAMIN ANGEL

Third, following the transition period, and in readiness for EU membership, the region undertook far-reaching reforms, which made it more >>>

>>> attractive for investment capital. However, more recently, reform progress has slowed, or even reversed. The region's success in attracting private (including foreign) capital and in absorbing EU structural funds is key for a transition towards knowledge based economies, increasingly specialised in high value added goods and services.

Are there differences across countries and across sectors?

There are some large differences, determined by both regional and idiosyncratic factors. To take one example, total investment in the Czech Republic has stood 5 pps above the EU average due to the weight of the manufacturing sector in the economy, which requires high equipment investment.

At the same time, although being a transit country places great demands on the country's infrastructure, investment in this area has been below EU average levels.

Do the current financing models in the region need to evolve? How?

Within the CEE, as in the EU, most financing is through banks. Equity and corporate bond financing is limited, institutional investors tend to be much smaller than in Western Europe and the CEE Region have lower access to venture capital. The development of capital market financing via Capital Market Union is thus particularly important for the EU CEE Member States.

The composition of investment has also tended to tilt towards tangibles. Increased investment in intangibles such as human capital and research would support technology uptake and increase innovation, notably by domestic SMEs. This is key to improve productivity and long-term growth that would benefits society as a whole.

What are the main challenges that need addressing in this perspective?

I would say that the three most important challenges facing the CEE countries are:

- reducing administrative and regulatory burden that tends to hamper investment, particularly for SMEs.
- fostering public sector efficiency, digital innovation and the quality of institutions. This would help to establish a predictable framework and reduce uncertainty.
- investing in education, skills and new talents. The lack of adequately skilled staff is a key obstacle to many investments, including in innovative and technological companies. ●

Steven van Groningen

President and Chief Executive Officer, Raiffeisen Bank Romania

Joint forces to overcome the financing and investment gap in CEE needed

Investments are essential in order to maintain and to improve the economic growth potential. In addition, for CEE countries, investment needs are even more stringent than for EU developed countries given their low levels of existing capital stock. Amid a benign global environment and in the context of the EU accession process, CEE countries faced strong foreign capital inflows in the years before the crisis inception in 2008 and investments boomed. Post crisis period is more challenging in terms of investing given that foreign capital inflows are scarcer and economic and political uncertainties that companies have to face have amplified, reducing so their appetite for investment. CEE countries not only have to modernize their underdeveloped infrastructure, but they also have to take care about investments in innovation (R&D activities) and in human capital as a key requirement of the new digital economy. With large funding needs, all available funding sources should be used: loans from domestic banks, loans from borrowing from abroad, EU funds, capital market, public-private partnerships and private equity funds.

Romania, for example, faces at a moment a large gap in terms of capital and economic development relative to the Euro area core countries. Country's funding needs for investments projects are impressive, as they have been accommodated in the recent years only to a small extent. Spending on R&D, education and healthcare is currently still among the lowest in the EU. Romania needs to make quality investments, particularly in infrastructure, for today and tomorrow. Foreign capital inflows have remained reduced over the past years as private sector, especially the banking sector, was in a deleveraging mood following a surge in indebtedness before 2008. Similar to other CEE countries, Romania's financing is too banking dependent. Other actors and new forms of financial intermediation will have to meet the credit needs of the economy. Having access to diverse funding structures is a main pre-condition for unleashing the growth and closing the gap to core Europe.

"Investments are essential to improving the economic growth potential of the CEE region."

\- STEVEN VAN GRONINGEN

Uncertainty related to the course of governmental and fiscal policies can hamper the appetite of companies for investments as is currently shown by the example of Romania. Fiscal space has been recently used to substantially increase wages in the public sector and pensions, which leaves a limited room for increase of public investments going forward (after they were cut in the last years). The recently introduced bank levy and the very elevated capital requirements for pension funds might restrain further financial intermediation. There might be significant positive implications for fiscal sustainability and long-term growth, if these decisions are reassessed.

Foreign investors role in the CEE development has been and will continue to be tremendous. Just as before, we need to join forces and commit to continue along this successful path and remove all the obstacles for financing and investment together. ●

Lucian Anghel

Chairman,
Bucharest Stock Exchange

Romanian capital market developments

The Romanian capital market has started in 2014 an ambitious reform in order to be upgraded to emerging market status by global index providers and, since September 2018, it is only one step away (as far as market liquidity) by the FTSE Russell classification. As per the FTSE Russell country classification review, the Romanian capital market was maintained on the Emerging Market Watchlist and is one step closer to obtain the upgrade. The single outstanding criterion is Liquidity – sufficient broad market liquidity to support sizeable global investment. FTSE upgraded from 'Not Met' to 'Restricted' the Liquidity criterion, following an improvement in broad market liquidity.

The global index provider MSCI published on June 20, 2018, its latest Global Market Accessibility Review. The report stated that Romania continued its efforts to improve the liquidity and participation in the stock market by lowering trading fees and encouraging more market makers to boost market activity, and that notable activities for the Romanian equity market also included the launch of Issuers Reporting Information System, where listed companies were able to release their communication to the market efficiently. Therefore, Romania's accessibility criteria were upgraded on 3 notes: market regulations, information flow and trading.

Although Romania is the second largest country in the region after Poland, the local exchange has a market capitalization/GDP ratio 3.5 times smaller than Warsaw Stock Exchange, and about 15 times less retail investors. This is a direct consequence of the low degree of financial education of the population. We are working with the capital market stakeholders, FSA and relevant authorities to implement measures at national level that support financial education, stimulate savings and diversify investments.

"Taking steps for increasing liquidity on the way towards emerging markets."

\- LUCIAN ANGHEL

Internally, Bucharest Stock Exchange is focusing on developing the market infrastructure by launching the local CCP solution, attracting private IPOs and bond listings as well as foreign investors in Romania. The CCP solution, approved by the shareholders in January 2019, is a prerequisite for launching the derivatives and further broaden the market offering.

On attracting entrepreneurs towards listing, Bucharest Stock Exchange is running in 2019 the 3rd edition of Made in Romania project, targeting 15 companies for the growth of the Romanian economy and their success stories.

About attracting foreign investors in Romania, Bucharest Stock Exchange has extended in the last years the range of targeted investors as well as the geographical region, initiated and took part in more roadshows and investor conferences, launched InvestingRomania.com information portal.

In parallel, the projects on qualitative improvement of the market are quasi permanent, like increasing the degree of corporate governance compliance for listed companies, within the framework of an EBRD supported project. ●

Sergiu Oprescu

Chairman of the Board,
Romanian Association of Banks

Closing gaps – between reality and outlook

Just as there is an intrinsic link between the degree of financial intermediation and the level of financial literacy, likewise the economic GDP growth and the optimum level of financial intermediation are directly correlated. In Romania's case, the degree of financial intermediation is set at 26% and the level of financial literacy is 22%.

As opposed to 8 years ago, financial intermediation has fallen by one-third. However, the banking system has the availability and resources to accelerate lending.

"Financial literacy and financial integration– solutions for reducing gaps in EU."

\- SERGIU OPRESCU

At the same time, a correlation can be identified between member states competences and the way it is being used in implementing European directives and financial literacy. If the level of financial literacy is below average, then the deployment of European >>>

>>> directives with certain deviations from free market financial principles, is easier. This generates a negative impact on the development of the banking system, the level of financial intermediation and financial integration.

Thus, this type of less perfect legislative implementations generates complications and sometimes even obstacles in promoting European fundamental values, such as the free movement of capital, services, etc.

Transposing and deploying these directives into national legislation can be made with errors, should we not take into account the level of financial literacy when legislating.

I believe that there is enough room to lower barriers that fragment national financial markets, thereby increasing financial integration in the European Union so that all states benefit from the same level playing field. Integration is generated by calibrating rules and practices.

Monitoring and sustaining a European program designed to increase financial literacy, is the solution for a better financial integration. As such, the cornerstone of this attuning should be to introduce in school curricula as a mandatory discipline for all European Union citizens, financial education.

Intrinsically, the fine tuning at the level of national competences, is recommended, when transposing and deploying European regulation.

The more affected some EU economies are by regulatory differences and lack of financial integration, the more negative consequences are there for the European family to annihilate: poverty and social exclusion, migration phenomena, etc. By removing these obstacles and the delay in the standardization of regulation, we reduce the risks of a future crisis. European Union countries have to move forward in the same direction and financial intermediation and financial literacy are the solutions to reduce gaps.

By fine tuning individual national competences as regards legislating/regulating, we can end integration efforts' fragmentation in the financial sector, as well.

In conclusion, it is necessary to adopt measures designed to increase and reduce the financial literacy gap across Europe in order to create a level playing field and strengthen the financial integration policy at European level. ●

Eurofi would like
to thank very warmly
**the Romanian EU
Council Presidency**
for their support to
the organization
of this seminar

romania2019.eu

**Participate
in the polls on the
EUROFI EVENTS App**