Note drafted by the Eurofi Secretariat

ADDRESSING THE FINANCING AND INVESTMENT GAP IN THE CEE REGION

On-going changes in the growth model of the Central and Eastern Europe (CEE) region

The CEE economies have recovered from the 2008 financial crisis and are enjoying relative economic stability. However potential growth forecasts in the region are deteriorating and the timeline for the completion of the economic convergence process is spreading out. In addition there is a persistent investment gap in the region in terms of quantity (approximately 4% of GDP)[1] and composition. This gap is more pronounced for NFCs (Non-Financial Companies) because EU funds tend to target mainly the public sector and infrastructure investments at present.

This means that the growth and financing model of the region will need to evolve in the coming years. The pre-crisis model involved a great deal of foreign investment going into labour-intensive industries and infrastructures, as well as portfolio capital coming into foreign-owned banks, both of which are expected to diminish in the future. Financing infrastructure and manufacturing plants will remain necessary, but there will be a need to place a greater emphasis on domestically driven productivity growth (requiring further investment of NFCs, particularly in the service sector, into new equipment and ICT i.e. information and communications technology) and the financing of more innovative, technology-intensive and high-growth industries. This will require developing workforce skills and a higher capacity to invest in intangible assets.

A rebalancing in the CEE region in favour of more capital market financing is necessary, but challenging

The financing model needs to be progressively diversified in the CEE region as a consequence of the economic evolutions mentioned above, with a greater role for capital markets, supported by a stronger local investor base with a long term perspective (pension funds, life insurance…). Capital market instruments and particularly equity are indeed more suitable than bank credit for financing innovative projects and intangible assets, because they have a longer term perspective and do not require the same guarantees, collateral, credit history or regularity of cash flows. In addition, compliance with applicable prudential requirements might restrict the availability of bank financing over time.

Several supply and demand-related issues need to be addressed. Banks finance at present 90% of the economy in CEE, which is higher than the EU average of 75%, and they focus mainly on traditional business such as loans and savings products. That said, a growing number of CEE banks have issued more innovative products such as covered bonds, which has helped local capital market development and expanded the product range available to local investors. This notwithstanding, local capital markets lack the scale[2] and capabilities that are needed to attract foreign investors and support larger issuers.

Companies in the region are mostly small and prefer debt financing. Their managers have limited experience of capital markets and perceive them as complex and costly to use. They are also reluctant to make the changes required in terms of governance and transparency. Retail investors based in the CEE region also generally do not participate in financial markets and mostly use cash holdings and bank deposits for their savings, all of which does not generate enough return for wealth to develop significantly. In addition the expansion of local institutional investors such as capital-funded Pillar 2 retirement systems may be hindered by decisions made by several CEE countries to revert to the traditional 'pay-as-you-go' system.

In this context, banks will continue to be by far the main source of financing in CEE in the short term, requiring credit conditions and the potential underlying factors (bank deleveraging, NPL issues, compliance with prudential requirements and local tax measures, etc.) to be closely monitored in these countries, and possibly additional measures to facilitate bank lending for innovative companies and infrastructure investment.

The actions that are underway at the EU and regional levels to develop capital markets and local financing resources need pursuing and expanding

The actions initiated at the EU level to foster the development of capital markets should be beneficial for the CEE region. Firstly, the efforts made to implement the EU capital market rulebook throughout the EU should provide the CEE countries with a consistent set of rules. This should facilitate the development of appropriate investment offerings across the multiple and relatively small CEE markets and also facilitate investment into the CEE region from other parts of the EU and third-countries. Actions proposed in the

[1] Maintaining the current capital to output levels would require the closure of a 4% of GDP investment gap according to estimates

[2] Capital markets account for less than 80% of GDP in the CEE region, compared to more than 300% in the UK and US. The CEE region represents 8% of the EU's GDP but only 2.5% of its total capital market activity.

context of the Capital Markets Union (CMU) should further support the development of capital markets in the region, however the progress made so far with this initiative is still limited. Secondly actions are being conducted under the aegis of the EU Commission in the context of the Structural Reform Support Programme (SRSP) to support the development and integration of local capital markets. Projects in CEE countries range from capital markets diagnostics and strategies, through SME equity listing support instruments and pre-listing support programs, to reforming the legal and regulatory framework for covered bonds and securitization, and improving the investment environment for institutional investors.

Multiple initiatives are also underway at the regional level, with the support of IFIs (international financial institutions such as the EIB and the EBRD), to develop and interconnect local capital markets. Work is under way to establish a Pan-Baltic framework for covered bonds, and an additional project aiming to obtain a single Frontier market classification jointly for the three Baltic countries to enhance the attractiveness of these combined equity markets to institutional investors. The SEE link project, also supported by the EBRD, aims to create a regional capital markets infrastructure by connecting the stock exchanges of 7 countries including Bulgaria, Croatia, Slovenia and N. Macedonia. A follow-up project is being implemented to connect securities clearing, settlement and depositary infrastructures at the regional level for the SEE Link markets. Local initiatives have been moreover put in place in Romania or Bulgaria for example[3]. Actions are also being conducted by the EIB through the EIF Investment Facility to support the development of venture capital and private equity in CEE, investing in funds that operate in the region and also providing investment expertise.

The IFIs moreover provide local banks with support, aiming to increase their lending capacity in the region. The EIB is supporting new securitisations and providing local banks with new risk-sharing mechanisms (through the SME initiative) that enable them to lend to innovative SMEs in an uncollateralized way. This includes providing banks with a first-loss guarantee on portfolios of loans to growing SMEs and innovative firms, which should help them to take more risks notably regarding intangible investments. The EBRD has helped implement covered bond reforms in several CEE jurisdictions, including Romania, Poland and Slovakia, with work ongoing in the Baltics and Croatia, bringing national regulatory frameworks in line with EU and international standards and providing these markets with renewed momentum in CEE[4]. ■

Paper based on the output of the Eurofi Vienna Forum (September 2018) and input from the EBRD

[3] For example, in Bulgaria a strategy has been implemented since 2016 for the development of capital markets through a Council for the Development of the Capital Market. Romania is also conducting actions to improve its position in the field of capital markets. Romania aims to be close to 30% stock market capitalisation out of GDP by 2023 (compared to 19% on average in CEE at present and 45% in the Eurozone), helped by new listings of private and state enterprises and obtaining an emerging market status in order to increase the visibility of the Romanian capital market to, in particular, international investors.

[4] The first AAA-rated transaction in the region was issued by a Slovak bank in 2018.