CEE REGION FINANCING AND INVESTMENT GAP

1. Changes in the growth model of the CEE (Central and Eastern Europe) region

1.1. Deficit of investment in the CEE region

A policy-maker stated that the CEE region is not expected to be affected much by the current economic slowdown in the EU, with a forecasted growth of over 3% in most CEE countries due to strong consumption and the assumption that EU funds will continue to be provided. During the last decade, the investment in CEE countries has been significantly above the EU average, fluctuating between 20 and 25% of GDP, but a number of factors suggest the persistence of a significant investment gap.

Firstly, the capital endowment of CEE countries remains well below the EU average. The level of investment is still inferior to what was experienced in countries that have successfully graduated from medium to high income and catching up would require a long period of higher investment compared to GDP. Second, investment is still below the pre-crisis level in a number of countries. It is not yet known whether that is a permanent or temporary factor, but the crisis has led to an increase in risk premia and Western European investors being more careful. Third, progress in reforms has slowed down, or even been reversed, in many CEE countries.

There are however some significant differences across countries and sectors. The Czech Republic for instance has benefited from a very high level of investment, 5% higher than the EU average. That is due to the weight of the manufacturing sector in the economy, which requires high investment in equipment. At the same time, there has been underinvestment in the country's infrastructure and its connection with other EU countries.

An IFI representative stressed that at present the investment to GDP ratio is aligned with the core European countries, which is a matter for concern because the latter countries have more mature economies, whereas the CEE region needs to build its capital stock much more and increase its investment capacity. An official noted that the capital stock in CEE is less than 50% of the EU average. The investment gap is particularly present in the private sector. In some CEE countries such as Slovakia, almost 75% of the overall investment comes from the public sector and relies on the so-called Cohesion Funds of the European Union.

1.2. Changing the growth model of the CEE region

An industry representative stated that many CEE economies have developed thanks to traditional manufacturing activities. Thanks to their geographical proximity with Western Europe they now play an important role on specific steps of the value chain that are outsourced from these countries. Some CEE countries however joined that trend fairly late and were disadvantaged because of their poor economic context and inadequate infrastructure.

The growth model of the region needs to change and be better adapted to ongoing industry trends, notably the development of technology. The use of technology for improving internal efficiency or customer experience is an area where CEE countries can perform very well. In addition, while building the infrastructure necessary to catch up with Western Europe and be sufficiently efficient in parts of the traditional manufacturing supply chains may take tens of years, the time needed to close the digital infrastructure gap with the rest of the EU could be a matter of months. In some areas CEE countries even have a superior digital infrastructure.

An IFI representative explained that innovation in the region is still limited. Recent research published by the EIB and the Commission shows that only 4% of firms can be considered as innovators in the CEE region, compared to 8% for the whole EU and 16% in the US. The region needs to develop its own investment capacity in research and development, which is at present very dependent on EU structural funds and foreign direct investment (FDI).

1.3. Developing digital skills and capabilities in the CEE region

An industry representative stated that further developing digital capabilities in the CEE region is essential and requires continued investment in education and reducing the current brain drain to other regions. A "pact for education" would be needed at the regional and national levels, in which all parties should participate. Providing entrepreneurs and individuals with an appropriate quality of life is also important, with the necessary infrastructure (in terms of education, health, transport etc.) and an environment that is favourable to technology and innovation. Successful entrepreneurs also need to be able to become richer in their own country, with the possibility for their company to develop along a critical path that eventually leads to public listing, which currently does not exist.

A policy-maker agreed that investing in education, skills and new talent to support innovative and technological companies is a major objective in the region. There is generally a lack of adequately skilled staff, which leads to skill shortages in many sectors of the economy, particularly in the most technologically advanced ones. This is indeed made worse by a large number of CEE countries facing the migration of skilled staff to Western Europe, which is primarily driven by a difference in wages. It is important for wages to continue to catch up, which however has to be in line with the progress in labour productivity in order to preserve competitiveness.

An IFI representative noted that almost 80% of CEE firms state that their biggest problem is access to people with the right skills. The issue is not the lack of skills produced by the educational system, but the outward migration from the region, which is generating a shortage of skills at every level, including at the lower ones. However, if unidirectional outward migration continues, incentives to invest in education in the region might decrease. More coordinated action at the EU level in terms of skills would be needed.

1.4. Improving the predictability of the regulatory framework

A policy-maker emphasized the additional need to reduce the administrative and regulatory burden that companies face in a large number of CEE countries. The World Bank annual ranking on the ease of doing business shows that overall the CEE countries do not score very high on this criterion. There is also a need to enhance the quality of policy-making and the predictability of the regulatory framework, which remains too instable in a number of countries, with frequent changes in legislation and a tendency to make these changes without sufficient consultation or impact assessments. These improvements are essential in particular to continue attracting investment from outside CEE.

2. The need to diversify the financing model towards more capital markets

2.1. Limits of the current bank-centric financing model in the CEE region

An IFI representative suggested that the almost completely bank-based financial system in the CEE region is a limitation to growth. The increasing need for investment in areas related to intangibles, R&D and skills is indeed not easily financed by banks, which normally require collateral to lend. Consequently a stronger diversification of the financial sector is necessary or a transformation of the way in which banks operate with regard to the financing of innovation and intangible assets.

An industry representative stated that to finance these new projects it is first necessary to understand what banks can and cannot do. Unfortunately, that discussion is often ignored at the political level with permanent calls for banks to provide more credit. Throughout and after the financial crisis, banks have taken too many risks and often found themselves in the position of an equity investor. Banks will remain the main financing source for the CEE economy going forward, the speaker believed, but it is extremely difficult for them to finance entrepreneurs or companies that just have a business idea and are undercapitalised, because banks work with their customers' deposits and cannot take excessive risks. That is a role for risk capital that companies need to better understand and have easier access to. Banks can then provide more financing following that first stage of development.

Another industry representative believed that financing needs to be provided by a combination of banks and capital markets. All channels are necessary. European banks are in much better shape than just after the crisis. They had lent too much before 2007, driven by nominal convergence, but since then they have had time to improve their situation and have benefited from eight years of growth. However, from a regulatory standpoint they are not in a better situation. Their ability to provide credit has not improved. The continuing wave of banking regulation and additional gold-plating by many EU jurisdictions will not allow banks to take more risks. In certain markets, banks could potentially allocate some risk capital to start supporting the critical path of some SMEs to capital markets and help to finance innovation, but this is not possible in the current European and local regulatory environment. Therefore, alternative instruments need to be organised. In addition more needs to be done in terms of financial and business development education, so that entrepreneurs can better understand the benefit for them of following a critical path that may lead them to the capital markets, with funding provided by private equity or investment funds investing in SMEs.

2.2. Complementarities and synergies between bank and capital market financing

Answering a question about the possible limitations to the development of capital markets caused by the present domination of the banking sector in the region, an industry representative did not believe that is the case. There might be some conflict between attracting deposits in banks and retail clients investing directly in the stock exchange, but that is not a major issue. Banks have learned that funding activities that can be better financed through the capital market is not necessarily an attractive business in the long run and they are quite active in supporting the listing of companies in some CEE countries.

Another industry representative believed that the dichotomy between bank financing and capital markets is a false one. The two are complementary in the way they approach the financing of growth. The problem is that the mix is not correct in the region, reflecting the fact that the development of capital markets is relatively recent and has never been at the top of the agenda of policy-makers and stakeholders. When looking at how to increase the funding provided through financial intermediation, two resources need to be considered. One is the capital base of financiers, primarily the banks. The other is the availability of liquidity and funds in the market. To bridge the two there are regulated instruments such as securitisation and covered bonds that can help to attract external savings and then contribute to increase the financing intermediation provided in the region. Any regulatory initiative that puts the capital base at risk runs counter to the interest of increasing financial intermediation in the local market.

A third industry representative agreed that banks are an interested party in developing capital markets, rather than an obstacle and that bank and capital markets are both needed. Everyone complains that the demand side in the region is enjoying a very low level of capitalisation. Creating the critical path from start up to listing for companies will help address part of the problem. It is important, when talking about capital market development, that different types of instruments, i.e. equity or quasi equity etc..., should be considered. The type of instrument that will be quite abundant in the coming years will continue to be EU funds. Banks have an important role to play in the fast and meaningful absorption of these funds. Spreading best practices in this area across the CEE region is critical, before considering a real development of capital markets.

Concerning the development of capital markets, a first step where banks can help is building awareness both on the supply and demand sides about the drivers of successful capital market financing and its main components in terms of instruments and participants. Banks can also contribute to putting together a network of interested parties in the different economies of the region (e.g. incubators, intermediaries etc...). In order to kick-start a more active capital market, banks could be allowed to take certain risks either directly or via a participation in specialised funds that they could later sell, once the funds have taken off. Building a successful capital markets union (CMU) is a journey rather than an objective per se, because it means finding solutions on an on-going basis for answering different financing and investment needs.

3. Challenges facing the development of capital markets in the CEE region

3.1. Limited financial literacy

An industry representative stated that more should be done for the CEE region to be on par with what is happening elsewhere in Europe in terms of retail investment. The starting point is a deficit in terms of financial literacy in many CEE countries compared to the rest of the EU.

Another industry representative agreed that financial education is a major issue in the region. Developing investment in the capital markets is essential for increasing long-term savings and the wealth of savers and also for channelling savings towards the European economy, but savers will not invest in capital markets if they do not understand the underlying mechanisms. Recent surveys show that financial knowledge e.g. about interest rate calculations or the need to diversify investment is poor compared to the rest of Europe.

At the same time, overregulation for example in terms of investor protection will not help the development of local markets and could be lethal for some smaller ones. Some large brokers have already stopped their activities in certain frontier and emerging markets in the CEE region and investors could be put off by the tens of pages of documentation imposed by MiFID II. The CMU is a very ambitious and necessary project, but unfortunately it does not include a workstream on improving financial literacy in Europe. The private sector is leading a certain number of actions in this area but that may not be sufficient. Public intervention is necessary to develop financial education, otherwise it will not be possible to increase wealth in the region through investments. The lack of understanding of financial mechanisms is also likely to increase the support for simple economic ideas provided by populist parties.

3.2. Regulatory barriers to the development of capital markets in the CEE region

Answering a question about the regulatory barriers that may impede the development of capital markets in the CEE region, an industry representative considered that a fine-tuning of the implementation of regulation could help, because in many cases, EU directives are twisted when transposed into the local market, which changes their initial intention. A second area of improvement is securities market infrastructures. Infrastructures do not exist in all markets (e.g. some central counterparties are missing) and their legal framework needs improving in some cases. Barriers also exist on the demand side, for example in local corporate debt markets, explaining their very limited development in certain countries. Some of these barriers are regulatory. For example, in Romania pension funds can invest in equities of almost any issuer but they cannot invest in debt instruments of the same issuers unless they are rated in a certain way. This having been said, the speaker did not believe that regulation could create the market. It is the market forces that will foster its growth. One challenge in this respect is that someone has to "pay the price" of developing the market. In most of the fast developing markets in the CEE region, the price has been paid by the early issuers that were floated on the exchange. Initially some of them were state-owned, then they were followed by an array of private issuers. Capital markets have to be helped at their outset in order to build confidence in the market.

3.3. Size and quality of enterprises in the CEE region

An industry player considered that the size and economic health of potential issuers is a further challenge in the CEE region. Most of the companies in CEE are micro-companies, which means that they are not compatible with the objectives of the CMU. This reveals an "entrepreneurial problem" that needs addressing in the region and that must be considered when defining whether funding should be deployed via the capital markets or bank financing.

An official confirmed that 90% of SMEs in the CEE region are micro-firms, which also have difficulties in obtaining loans in many cases.

An IFI representative considered that the future of risk finance in CEE is more about private equity than capital markets, because raising capital on public markets is difficult for most small firms. Instruments such as private equity or venture debt are more appropriate and need developing. Well-functioning banks should also be allowed to progressively take more risks using such instruments, perhaps supported by institutions like the EIB.

4. Possible way forward for developing more capital markets in CEE

4.1. An appropriate ambition and workplan for developing financial activities in the region

An industry representative stated that an ambition for the development of financial markets as a whole i.e. banks, stock exchanges etc. needs to be defined in a collective way at the national and regional levels together with appropriate objectives. Then, the actions required to achieve this ambition need to be defined. Some can be very basic, such as providing a more predictable regulatory and fiscal environment for investment and limiting unnecessary volatility. Retail investors cannot be expected to invest in the stock exchange when, as the result of government action, there are sudden drops in value of 20% almost overnight.

Another industry representative suggested that developing the capital market involves considering the demand and supply sides and also the infrastructure in the middle. On the demand side it is necessary to look at all the components i.e. domestic / international, retail / institutional, etc. Sufficient institutional investors need to be present in the system, particularly pension funds without which it is difficult to develop capital markets. Retail domestic investors also have to be considered and whether the level of education and financial literacy are sufficient in the country. On the supply side, it is necessary to address potential regulatory and non-regulatory barriers to the development of equity or debt markets. Moreover, it is necessary to assess the possible need for further developing securities infrastructures and improving their functioning or regulatory environment.

4.2. On-going EU initiatives to enhance investment in the region

An official noted that there are already significant ongoing EU initiatives and instruments provided by the public sector aiming to support investment and the development of capital markets in CEE, such as the Vienna Initiative and the Structural Reform Support Programme.

An IFI representative explained that in the context of the Vienna initiative the EIB has been working with the IFIs and commercial banks operating in the region to assess which tools are working and identify additional ones which may need to be implemented to finance innovation in the region. What stood out in these assessments is that venture capital financing at a very early stage is well covered, because there are many public sector resources. The problem starts at the scaling up phase, which is when firms lack financing.

The EIB provides various instruments aiming to tackle the issue of innovation finance: a capital relief product and a guaranteed product, which is greatly appreciated by banks, particularly when they are structured to take the first losses out from a portfolio. This helps because it reduces capital consumption and allows banks to service clients that they would not necessarily have been able to address otherwise. This instrument is managed by the EIF (European Investment Fund), which is part of the EIB, and provides around € 1.4 billion funding, specifically injected in the region on this project.

Secondly, for the scaling up phase, a complementary financing product - venture debt - is being tested at the European level that is not capital but risk financing. It is a product that is difficult for banks to offer, mostly due to regulatory constraints, because the capital consumption would be too high.

A policy-maker stated that developing investment remains the number one priority of the Commission. A couple of years ago the Structural Reform Support Programme (SRSP) was established aiming to accompany the effort of member states in developing structural reforms. More than 200 projects have been financed in 2018 and there should be about 260 in 2019. In many countries, those projects consist of helping to develop the financial market, which is an important priority in the CEE region.

In the next MFF (multiannual financial framework), efforts to support investment will be stepped up. InvestEU, which will be a single guarantee, will be launched, replacing all the financial instruments that currently exist. The EIB will be present, but for the first time the Commission will allow the National Promotional Banks to have direct access to the European guarantee. This combination of European and local level expertise should help to develop investment in a more effective way.

4.3. The possible need for additional and more targeted support from the EU and local public institutions

An industry representative believed that without further support from the public institutions it will be very difficult to develop capital markets sufficiently in the CEE region, particularly in a context of slow economic growth in the EU.

The EU needs to design instruments that would allow the private sector, and not only governments, to ask for European funds to support certain projects. This could be applied in certain areas that require targeted action. A first area is financial education. Developing capital markets indeed requires improving retail investor and also issuer education through action targeting the general public. The private sector should be allowed to tender for projects involving public money in order to develop financial education. Targeted actions supported by European funds could also be used to shore up the issuance of securities in the market. European Funds could be used for example to cover part of the cost of issuance of bonds on the capital market or of IPO costs. Support programmes could also be designed to help simplify and accelerate the listing process, improve research coverage in the CEE region or create regional ETFs.

Another area where public support is essential is tax incentives, the speaker emphasized, because they are probably the fastest way to develop capital markets. Tax incentives should be used to encourage long-term investment, for example in the context of employee stock option plans. Corporates should also be allowed to deduct a part of the cost of a bond issuance or listing cost from their taxable benefits.

Another industry speaker considered that it would be preferable not to use special instruments or incentives to convince people to put their money into the financial system of CEE countries. This should be the result of an attractive ambition defined for the financial market at the regional or national level with all stakeholders.