

Access to Financing in Southeast Europe: Before and After the Crisis

Executive Summary

Introduction and rationale

Since 2005, the Regional Competitiveness Initiative (RCI), a project sponsored by USAID, has been providing technical and financial assistance for entrepreneurship, industry and policy development in the countries of Southeast Europe and the Caucasus. In planning a second generation of activities, in 2009 RCI took into account a broad set of factors related to increasing competitiveness in these regions, as well as mitigating the effects of the ongoing economic and financial crisis.

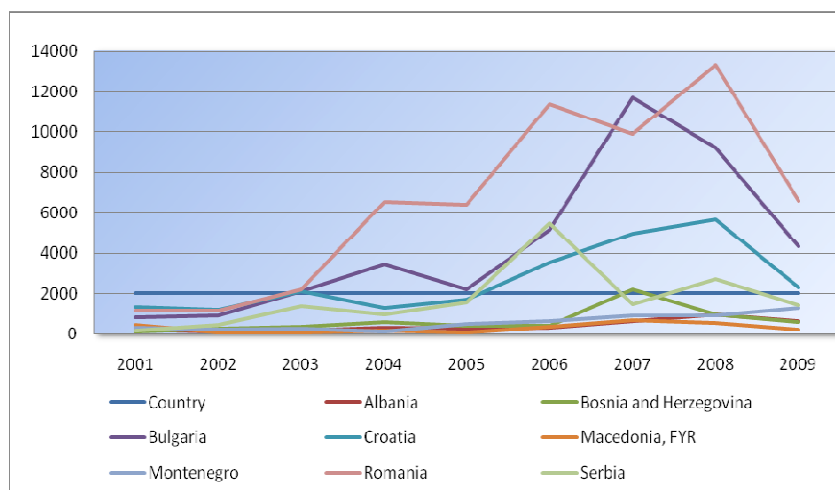
This report will primarily present, discuss and analyze data related to the Southeast Europe region - Albania, Bosnia & Herzegovina, Croatia, Serbia, Macedonia, Kosovo, Montenegro, and Bulgaria and Romania (i.e., EU member states since 2007), also known as the countries of the Western Balkan region.

Since all of these countries are to a great extent integrated within the global economy yet struggle with economic, administrative, social and political challenges, development and implementation of reforms there largely depends on their access to foreign capital and the overall performance of their main trading partner and primary funding contributor – the European Union. In this respect, this report strives to provide an exhaustive survey of the type, scale, target and origin of investment activity in the region before and after the global economic downturn, as well as findings and projections related to other factors that have proved crucial to the overall growth and competitiveness landscape of the region.

Access to financing and growth-enhancing factors prior to 2008

As a part of the global economic boom in the years prior to 2008, the region primarily benefited from enhanced FDI activity, originating mainly in the EU. Attracted by the benign location of the countries, large scale privatization, low labor cost, favorable tax policies and palpable fragmentariness and lack of saturation in certain sectors, strategic investors and investment funds from abroad stepped in and considerably increased rates of GDP growth in all of the countries. Special interest in the tourism, real estate and construction sectors was evident, as massive amounts of foreign capital were invested there. Another example shows that as of 2010, sixty percent or more of the banking and financial intermediation sector of the region had been acquired by foreign (mainly EU based) entities.

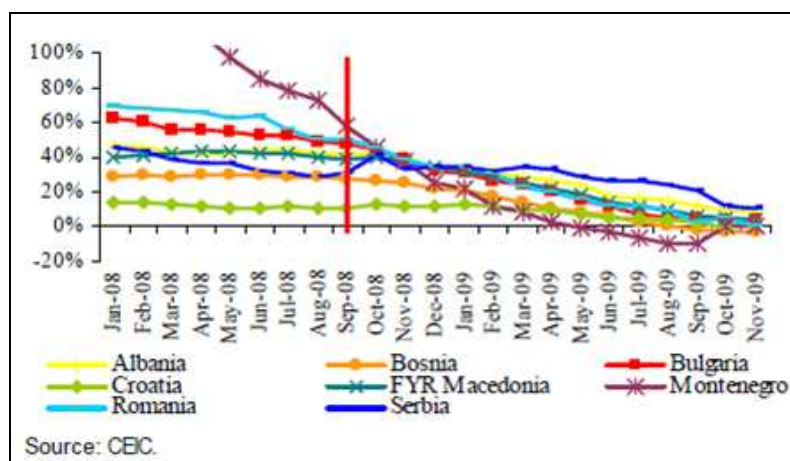
Graph 1. Inward FDI in the SEE region (USD million) in the period 2001 - 2009



Source: Countries' national banks, countries' investment agencies, UNCTAD, MIPA

Next to that, growth in the region was boosted by facilitated and unobstructed access to bank lending. For example, a 50 percent raise in bank loan growth helped Romania's economy double in size from 2004 to 2008 (the Economic Times; CRB's data), while a similar trend gave Bulgaria and Serbia a big boost. Nevertheless, in the second half of 2008 many of the countries experienced a decline in credit lending, which deteriorated further in the beginning of 2009.

Graph 2. Credit growth in the SEE region, year-on year in percent



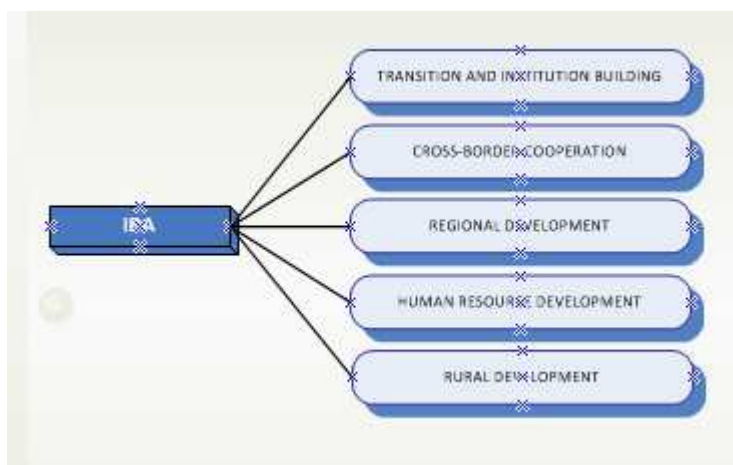
Source: CEC.

[The EU](#), [USAID](#) and a number of International Financial Institutions (IFIs), including the [EBRD](#), [EIB](#), the [World Bank](#), [IMF](#), [GtZ](#) and [KfW](#), among others, have also played a major role in enhancing the countries' overall economic performance. Considering the dire state of development in the region, structural assistance has been provided to all of the countries, considering individual needs and addressing priority areas such as administrative capacity and infrastructure building, fiscal stability, legislation and rule of law enforcement, [cross-border cooperation](#)¹, etc. This type of assistance is of great importance for these countries, as it

¹ Montenegro cross-border cooperation framework under the IPA

primarily aims to identify and obviate deficiencies which may hamper the countries' long-term competitiveness.

Figure 1. IPA's five fundamental components

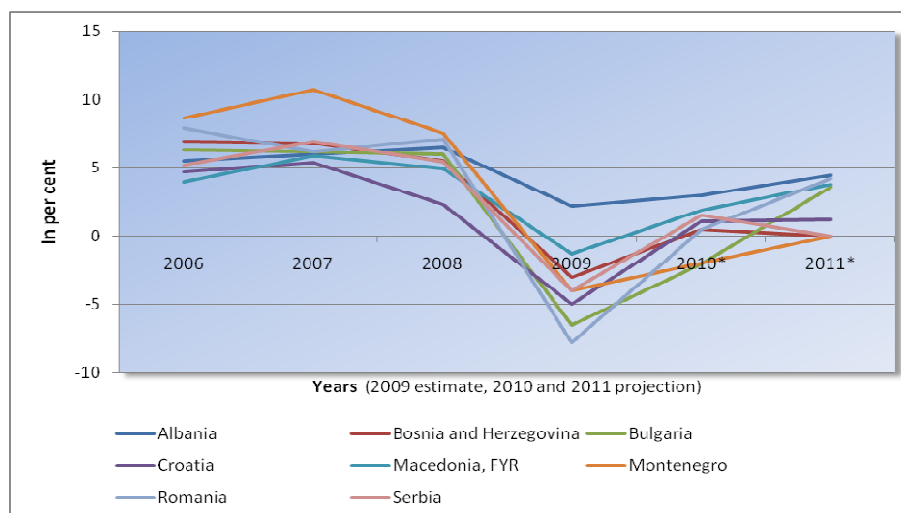


Source: IPA

As a result of a slumping economy on a global scale in 2007-2008, investment interest in the region registered a sharp downturn. Strategic investors and investment funds either ceased operations, or tended to migrate to the faster-growing markets of Asia. Additionally, with the ongoing recession in the Eurozone in 2008, the banking sector in the region sensibly contracted and levels of credit lending sank tremendously, as access to financing became more limited and expensive.

Commendably, macroeconomic stability and the continuation of reforms were safeguarded in the Southeast European region, as governments and external entities such as the EU, USAID and the IFIs took timely and adequate measures to retain confidence in the economies, announcing crisis response packages and securing liquidity inflows to the business sector.

As of April 2010, the countries in the SEE region are still in a process of weathering the worst threats of the crisis; in fact, figures already show slight trends of stabilization and growth. Although rates of unemployment have risen significantly for the period 2008-2009 (Center of Public Employment Services of Southeast European Countries) and access to financing has become more expensive and difficult to attain, no signs of major economic, political and social disturbances have been evident, nor are there present projections for such. Moreover, ongoing reforms have been further implemented despite the crisis and slight signs of economic improvement are already evident.

Graph 3. Growth in real GDP in Southeast Europe 2006 – 2011

Source: SEE's central banks

Growth factors and opportunities that lie ahead for the region today

Based on the conducted interviews with economists from the region, this report predicts that the countries to come out of the crisis first and to attract foreign capital will not necessarily be the first countries to register better rates of GDP growth. Gaps in the development rates in the region can be large; hence what is considered progress in one country may be regarded as a dire condition in another. For example, countries such as Albania, Bosnia and Herzegovina, and Kosovo do not yet show sufficient administrative, workforce and infrastructure capacity to assume, host and safeguard investment on a large scale. Several other factors that this report takes into account (besides GDP) are the EU accession status of the country, its relative market share and its overall preparedness in terms of human capacity, legislation and available infrastructure, as principal in determining the future of the region.

As of 2010, our projection is that the first countries to show better economic performance and to lead a new investment trend in the region will be Croatia, Romania and Bulgaria, followed by Serbia and Macedonia. The main reason for this assumption is the fact that while these countries are the most advanced in their relations with the EU (Romania and Bulgaria have been official EU members since 2007, while Croatia is an officially recognized candidate), hence they benefit from the most intense EU funding for the real sector and free access to the Single European market, they also enjoy functioning market economies and human capacity preparedness to institute reforms and provide guarantees for the security and sustainability of foreign investments.

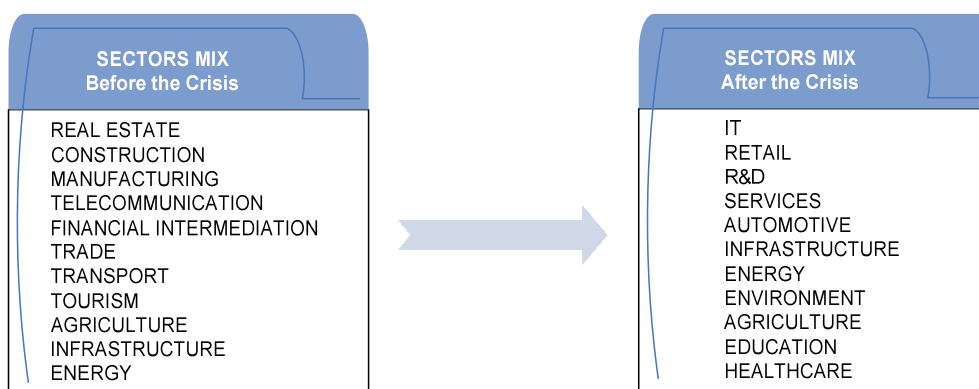
Facing more difficult conditions and holding the status of potential EU candidate countries, Albania, Bosnia & Herzegovina, Kosovo and Montenegro will continue to benefit from intensive funding from both the EU and IFIs with the general aim of enhancing necessary reforms in administration, fiscal policies and labor market efficiency, in order to pave the way for EU membership and FDI. Commendably, despite crisis conditions, Albania and Bosnia & Herzegovina continue to carry out reforms and to register sustainable rates of GDP growth. However, the lack of energy and water supply infrastructure in Albania is a concern for

investment and general economic development. As stated, however, since international institutions have prioritized such projects with subsidies, these deficiencies are due to be rectified in the near future, while improvements in judiciary and workforce capacities are also expected. In conclusion, although performing well in the current crisis conditions, these countries have a long way to go before being able to turn into a sound investment hotspot. This is likely to happen in the years after 2014, when reforms will have taken more palpable effect and an EU accession is indicatively scheduled for these countries. Until then, major capital inflows are expected to come predominantly from international entities such as the EU, USAID and IFIs in the form of structural aid and lending.

Attractive sectors and investment sources

Privatization of key assets in telecommunications, manufacturing, transport and services is expected to remain a principal factor in investment attraction in the countries, especially in the non-EU members. A general outflow is expected in real estate and construction, as well as in tourism and banking and financial intermediation services sector, since these markets have been to a large extent saturated in previous years and do not present a favorable market niche. At the same time certain other sectors, such as **ICT, Energy, Infrastructure, Retail, Healthcare and Education, Agriculture and Environment** are expected to provide opportunities for Greenfield, Brownfield and other types of investment in addition to privatization.

Figure 4. Investment Interest - Sectors mix before and after the crisis



Source: SEE Sectors research 2010, BC Serdon

Given the constantly increasing need for **energy** throughout the SEE Region, the concerns about global warming due to rising CO₂ emissions, and the notion that renewable energy (e.g., hydro, wind, solar, biomass and nuclear) will be among the primary energy sources of the future, energy companies are allocating resources to energy projects in Southeast Europe. Considerable improvements are anticipated in the development of the energy sector in Albania. On the other hand, two major projects for gas deliveries from Asia to Europe are underway – the European Nabucco pipeline, which goes through Bulgaria and Romania, and the Russian South Stream pipeline, which is projected to cross Bulgaria and Serbia. In the field of nuclear energy, Bulgaria has announced its determination to proceed with the construction of its second nuclear facility – Belene – only if a European strategic investor is involved.

The retail sector will also draw investment interest, mainly due to the considerable fragmentation of the sector. The current supply-demand chain in the region is far from optimal,

implying higher transactional costs, which large retail-chain entities can reduce by consolidating the sector and profiting from advantages of scale. Multinational enterprises such as IKEA, Wall-Mart and Delta MAXI have already announced their intentions to expand in the region.

The agricultural sector of the region is also to a large extent fragmented and dominated by small, individual farms, not all of them market-oriented. This rather uneven structure causes an unsuitable and unstable ratio of the number of farms to the total area of arable agricultural land, which leads to lower competitive advantages and lower productivity within the sector. In this respect, agricultural policies in all of the countries of the region foresee the introduction and implementation of broad market reforms, which will eventually lead to a more balanced and effective sector. These initiatives are subject to funding and technical assistance from the EU, IFIs and national budgets and promise to improve the sector's potential in the coming years.

A clean environment and waste treatment are priorities for the European Union Environment Policy, and as members, candidate members, or potential candidate members of the EU, all of the countries qualify for financial and technical aid from Brussels for development of the sector. With rates of recycling close to 0% in all of the countries and with sanctions already being imposed on some of the countries for not complying with EU criteria, this sector is regarded as highly promising.

The manufacturing sector is also expected to attract investments, especially in the automotive industry. There are talks of opening Fiat and SAAB plant factories in Romania, while in Montenegro, the Italian sports car manufacturer Lamborghini is due to open an electric car factory. In December 2009, another Italian car manufacturer, Fiat, bought 67 percent of the Serbian Zastava Automobili for 200 million EURO and has now announced plans to build a new plant in Serbia. It plans to invest another 500 million EURO by 2012 with the goal of exporting 95 percent of the output to western countries.

Given China's ambitions to a global position in the automotive sector, strategic interest from Chinese companies is also to be expected, but perhaps at a later stage. Today China generally prioritizes acquisitions of major strategic entities on a global scale – as the recent acquisition of Volvo by the Chinese Zhejiang Geely Holding Group shows. In the years around 2014, however, when at least some of the Western Balkans countries are due to accede to the EU, increased interest by Chinese companies is to be expected, as they will use the Western Balkans as a manufacturing and outsourcing hub for their EU-market-related operations. In this respect, growth indicators of the Eurozone will also play a crucial role in the attraction of Chinese investments in the Southeast Europe region.

Until then, countries like China and India are expected to mainly channel funds into portfolio investments in the region, along with European, Russian, Middle Eastern and local stakeholders, as a means of financial portfolio diversification and risk alleviation. No major projects of strategic importance and considerable scale in the region have been so far announced by companies from Asia.

Conclusions

According to the findings of the Global Competitiveness Report 2009-2010, some of the most problematic factors for doing business in the SEE countries were: (i) widespread corruption, (ii) inefficient government bureaucracy, (iii) policy instability, (iv) obstructed access to financing, (v) inadequate supply of infrastructure and (vi) inadequately educated workforce.

Findings from interviews with investment funds and major strategic investors active in the region show that the lower degree of corporate culture preparedness is also a major obstacle for the sustainability and soundness of foreign investments in the region. Common business practices, such as development of a business plan and accounting practices, have been adopted and strictly applied by a large number of economic entities in the region. For many others, however, these practices remain obscure and imply a distorting effect on competitiveness and the overall sophistication of the market environment.

However, countries and entities across the region show growing capacities for tackling these issues and creating a better business and investment environment. Additionally, with growing confidence in the economic performance of the eurozone, exports from Southeast European countries to EU countries are expected to rise and produce a favorable effect on both unemployment figures and trade deficits. Thirdly, as the countries' EU accession processes progress, investment opportunities will also increase. Access to EU funding will be available in a number of sectors, while in their investment decisions companies will focus on free access to the EU Single market, which these countries will enjoy after their successful accession to the EU.

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