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Investments in CEE: switching into next gear of growth

In order for the growth potential of CEE countries to switch gear, the region needs double-digit growth of investments. We see last year as a turning point in the investment cycle, with a positive effect on higher job creation and wage dynamics. For investment growth to be sustainable, CEE countries need to activate private investments and keep them in check with domestic savings and EU transfers, while capital markets have to play a greater role in the funding of long-term investments.

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The recent improvement of market sentiment allows for optimism about the investment growth outlook in the near future. Due to the pro-cyclical behavior of investment, growing confidence is necessary to restart investment activity, but insufficient to restore double-digit and sustainable growth dynamics. In order to return to pre-crisis potential growth dynamics, which stood at 3.7%, investment growth above 10% is needed, in our view. In the long-term perspective, this can be only achieved when CEE is successful in addressing structural aspects, such as reducing labor market rigidities, increasing the transparency of the legal environment and simplifying administrative procedures that create favorable conditions for the development of private investment. Those factors are especially important for SME investments, which are very desirable because of their less pro-cyclical feature, higher marginal return on capital, positive effect on job creation and productivity growth, thus blending all of the positive aspects for ramping up the potential growth. Furthermore, a new approach to financing should be considered. As FDI and external loans lose out in importance, more attention should be paid to domestic savings, EU transfers and the development of capital markets.

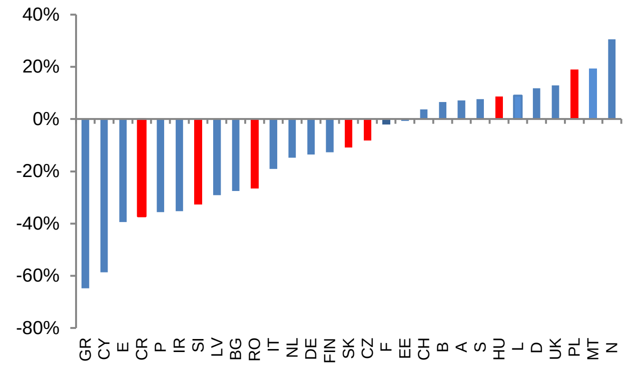
In the near future, we see the greatest investment opportunities in infrastructure and environmental projects, due to the higher allocation of EU funds to the region. Moreover, CEE countries have a decent chance to obtain a large slice of the Juncker investment plan, but the immediate impact of the plan on investments should not be overestimated; size-wise, the package is relatively small compared to overall investments in the EU. More important positive aspects are seen in the way that the Juncker plan incentivizes the idea of venture capital, which has been scarce in Europe, and tries to give a boost to capital markets. Another advantage of the program is that projects that are relevant for building a better and more competitive business environment within the EU should get strong political priority and relatively favorable financing.

Investment back in play

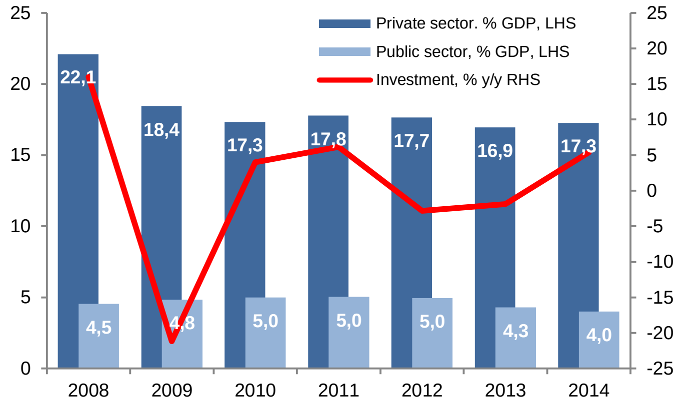
Countries in region seem back on track

Dynamic growth of investment is one of the pillars of the CEE convergence story and the underlying force of the catch-up process. We see last year as a turning point in the investment cycle and expect positive trends to remain. Compared to 2008, Poland and Hungary already have higher levels of investment. Poland is an investment leader compared to its regional peers, as it has experienced the highest investment growth since the beginning of the crisis, supported strongly by public investment when other countries were coping with fiscal consolidation. Hungary follows Poland with investment growth as high as was seen in Austria, Sweden or Luxemburg. Moreover, investment in Czech Republic and Slovakia should go above pre-crisis levels this or next year, as improving business sentiment enhances expansion. Croatia, Slovenia and Romania, however, will require stronger recovery to restore pre-crisis level of investment, as improving economic sentiment, that triggered revival of investment in other CEE countries seems insufficient to restore double-digit growth dynamics.

Growth of investment in CEE 2008-14, %



Private and public investment in CEE, % of GDP

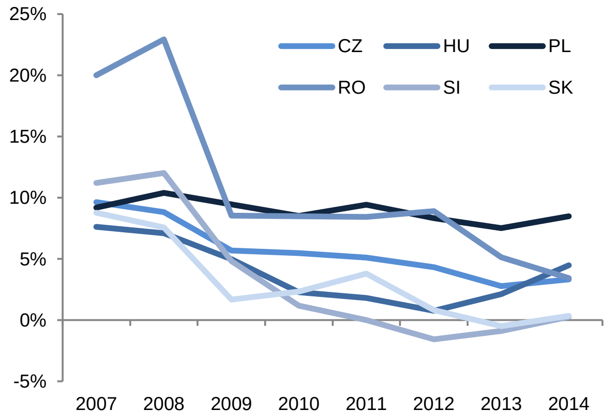


Source: AMECO, Erste Group Research

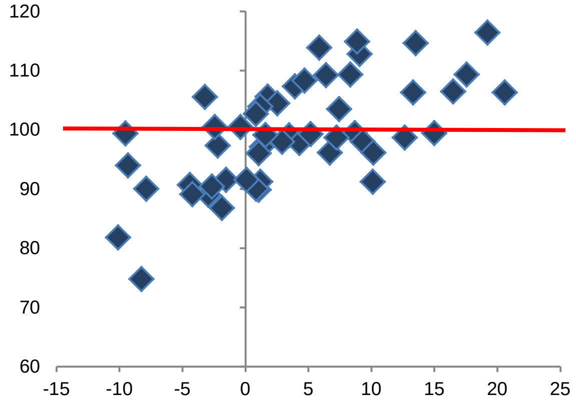
Increasing confidence restarts investment engine

As mentioned above, due to the pro-cyclicality of investment, we see the recent improvement of business sentiment as an enhancement to increase economic activity and support for the revival of investment on local markets. The strong rebound of leading indicators such as PMIs is a promise of increasing production that is usually demand driven. In other words, as private consumption, supported by improving labor market conditions, increases, the number of new orders grows, which first boosts investment in production capacities. Throughout the last few years, economic sentiment has been rather depressed, making companies extremely cautious in their investment plans and meaning that the high level of uncertainty was holding off expansion. Recovery of economic sentiment to its long-term average in most CEE countries allows for optimism, as it keeps investment growth in positive territory. Increased confidence is a necessary condition to push net investments onto a path of solid growth. While we see the signs of net investment (as % of GDP) returning to an upward trend in all CEE countries but Romania, more investment is needed not only to cover depreciation but also to increase the capital stock more prominently and boost production capacities further.

Net Investments, % of GDP



Economic sentiment and investment growth, % y/y

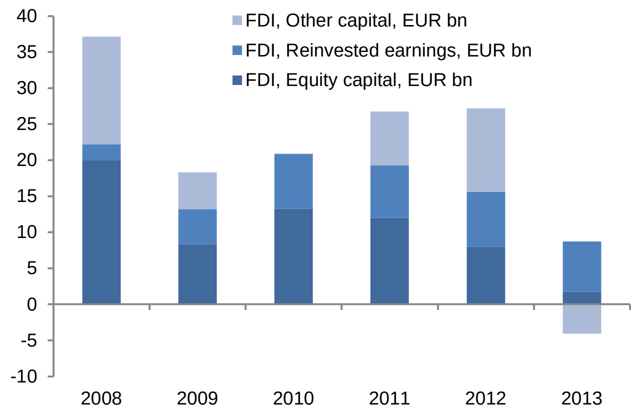


Source: AMECO, European Commission, Eurostat, Erste Group Research

In order to restore pre-crisis growth potential, investment growth should be in double digits and reach at least 10%. Such dynamics of growth was often observed before the beginning of the financial crisis in 2008 – an event which was an indisputable game changer for the investment landscape. The sudden drying up of capital inflows or even the reversal of capital flows from emerging economies forced countries to rapidly narrow their current account deficits. As a result, investment growth plummeted by more than 20% in 2009 and in consequence the share of private investment (as % of GDP) visibly dropped. CEE was not unique in terms of decline of investment rates.

The decrease in private investment was part of an overall global trend, as production was excessive while global demand was sinking. In the aftermath, inflows of foreign capital were substantially reduced across the world. In our view, FDI inflow is going to decrease in importance in terms of financing investment in most CEE countries in the upcoming years. As the FDI inflow was driven by the privatization process to a great extent, we expect to see lower levels of incoming funds from of FDIs now that this process is mostly completed in many countries. In our view, only Croatia, Serbia and Slovenia still offer some potential, as privatization projects are on the way. We thus see room for local investors to become more important for the investment development, especially as economic momentum has become favorable for investment.

FDI net inflow, EUR bn



Source:, Ameco Erste Group Research

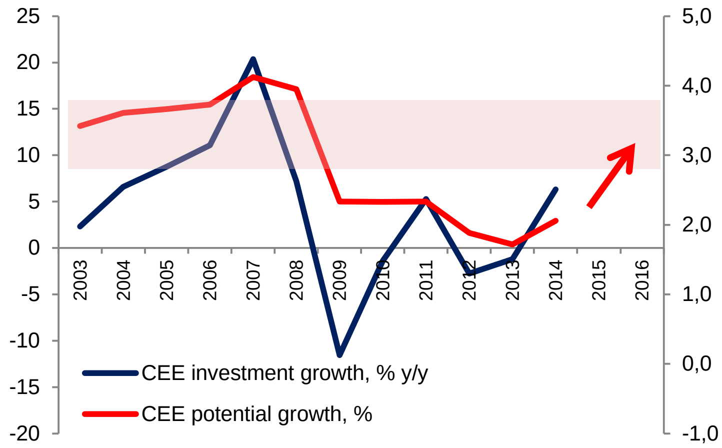
Boosting investment is a key factor in restoring growth potential

We still see great potential for CEE countries to benefit from capital accumulation. Although the pace of convergence has slowed down, CEE countries are continuing the catch-up process. Boosting annual growth of investment to 10-15% in the coming years would be required to restore the pre-crisis rate of potential growth[1], which stood at 3.7% and is currently estimated to be close to 2% in CEE. In order to achieve that, CEE economies should focus on taking advantage of favorable economic momentum and positive sentiment. As investment growth is highly pro-cyclical, the business cycle becomes an important factor impacting investment activity. Recent improvement of local and external demand increases the opportunities for firms to sell their products and in consequence the number of new orders has been growing. In order to satisfy that demand, firms need to increase production capacities that have been reduced during recession and so begin to invest accordingly. Strong product demand and increasing sales lead not only to expansion of production but also to a better financial situation for firms. It is very often a pre-condition for activating credit channels, which in turn allows the financing of further investment.

Structural changes most important for permanent increase of investments

In the long-term perspective, cyclical factors are not sufficient to boost growth potential. There are other factors, some of which are structural in character, that impact investment activity in the region. First of all, a competitive position on the domestic as well as the international market is positively related to investment growth, as either improving the market's position or sustaining it necessitates investments. In the case of the CEE region, remaining an attractive destination for both domestic and foreign investors by having a common level playing field might be crucial for investment and, ultimately, economic growth. In our view, the CEE region should pay more attention to other structural aspects, such as a qualified workforce and labor costs as well as the legal environment. Among the most common factors limiting investment are demand barriers (not enough domestic or external demand), the lack of a qualified workforce, as well as high costs of labor, shortages on the input markets or high overall cost burdens and a complicated legal environment. While demand barriers are tied to the business cycle, a less rigid labor market as well as a transparent and stable legal environment could be improved through structural reforms that would further support investment activity and boost growth potential.

Investment %, y/y and Potential growth, %



Source: European Commission, Eurostat, Erste Group Research

[1] Calculation is based on the assumption that Labor and TFP contribution are at their long-term average (0pp and 1.6pp accordingly)

Heat map of priorities

Governments ready to support investments

With private investments recovering slowly, governments now feel more of a duty to boost investments. Although many governments have improved their budgets significantly, there is limited fiscal space for any extensive boom in public investments directly financed from budgets. Elevated levels of public debt and not fully eliminated structural deficits are the main hurdle for more ambitious fiscal expansion.

Juncker's plan aims to mobilize both private and public investments

It is not surprising that boosting investment activity is at the top of the agenda for European politics. Juncker's Investment Plan hopes to give an initial boost to investments with a targeted investment package of EUR 315bn over the next three years. The magic is that it is supposed to bypass financial constraints of governments, as the seed capital (loss-absorbing part of investment) will be provided by European Fund for Strategic Investments (EFSI) where the EC and EIB will contribute through guarantees worth EUR 21bn and the EIB will prepare a structured investment scheme to leverage the initial investment. Thus the major part of funding is supposed to come predominantly from strategic investors and private financial investors. This crowding in of private investors seems a good idea, as it should select only economically-viable projects and improve the efficiency of capital allocation.

Governments incentivized to add more money on top of EFSI for Juncker's plan

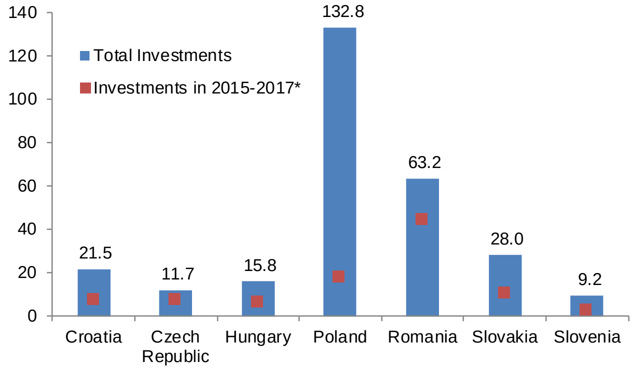
It is quite clear that, for some investment projects, governments will play the role of a strategic investor and thus not exploit the full potential of leveraging investments with private money. Governments are even incentivized to increase the amount of capital for the EFSI and co-finance projects via vast exemptions in current fiscal rules valid in the EU.[2] However, countries with self-imposed debt brake rules, like Slovakia or Hungary, could be constrained from fully benefiting from these incentives. Some governments have already published how much money they are going to provide on top of the EFSI for Junker's plan via their national development banks. From CEE countries, only Poland has already pledged to contribute by an additional EUR 8bn through its state-owned bank (BGK). The positive aspect of this is that CEE countries should be allowed to use Structural Funds for the co-financing some projects and are even endorsed by the EC to do so.

CEE countries have good chance to slice EUR 40-60bn from Juncker's plan

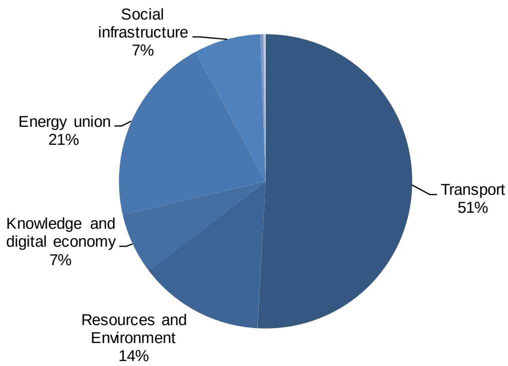
CEE countries have already submitted project proposals to the EC and EIB worth EUR 282bn (out of EUR1.3tn), and the Investment Committee will choose from these. We think that projects supplied by CEE countries have a good chance to be shortlisted, as there are many projects devoted to the energy infrastructure and digital economy at high levels of readiness (to be financed in 2015-17), which should meet the main objectives set by the EC. In fact, the project for the expansion of the Croatian airport was among the first four projects earmarked by the EIB to benefit from Junker's plan. From the total list of projects worth EUR 1.3tn, only EUR 500bn is to be invested in 2015-17. The projects submitted by CEE assume EUR 95bn to be invested in the period 2015-17. Although Juncker's plan explicitly states that there will not be any country or sector quota, CEE countries have a good chance to carve out about EUR 40-60bn or 1/8-1/5 from the whole plan. That would correspond to EUR 3-4bn of loss-absorbing money from the EFSI, with the rest financed by strategic investors and private financial investors.

[2] Excessive deficit procedure, preventive arm of Growth and Stability Pact

Investment projects submitted by CEE countries for Juncker's plan (EURbn)



Sectorial breakdown (% of investment costs)



*Source: EIB, Erste Group Research, Note: * Information about required investments in 2015-2017 was not disclosed with some projects*

Size-wise, Juncker's plan brings little direct money compared to EU funds….

We should not overestimate the immediate impact of Juncker's plan on investments. Size-wise, the package is relatively small compared to overall investments in the EU (4% of total investments per annum). In terms of direct money received from the EFSI, EUR 3-4bn is very little compared to the EUR 185bn pot of EU funds available for CEE in the programing period 2014-20. Thus the main benefits of the Juncker plan is that projects which are relevant for building a better and more competitive business environment within the EU should get strong political priority plus relatively favorable financing.

…but targets private investors and development of capital markets

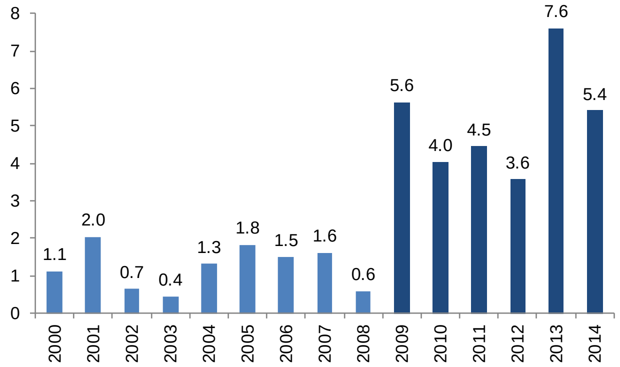
Easy access to financing and the financial development of the country are important for the effectiveness of the investment channel. Bank lending has dominated CEE for decades, while capital markets have played a minor role. Juncker's initiative addresses two main weaknesses in the financing of investments in Europe. It partially imitates venture capital, which has been scarce in Europe, and tries to give a boost to the capital market. Capital markets seem better suited for financing long-term projects, where bank lending is constrained by tougher liquidity rules. The European Commission has already released its Green paper on building a Capital Market Union.[3]

Bond issuance still small in CEE, but has increased substantially since beginning of crisis

The possibility to obtain funding from the market seems especially important for large companies and sectors where banks can reach their credit limits or for long-term projects where the maturity profile does not fit with the short-term liabilities of banks and would thus be costly from a regulatory perspective. Although the corporate bond market is still very underdeveloped in CEE, the issuance has increased since the beginning of crisis (from an average of EUR 1bn to above EUR 5bn per year). Since 2009, CEE countries have issued corporate bonds worth EUR 31bn, with Czech companies being the largest issuer (EUR 10bn), followed by Poland (EUR 8bn), Slovakia and Croatia (both about EUR 4bn). Companies from the energy, telecom, engineering and media sectors dominated in terms of corporate bond issuance.

[3] For more details, see Green Paper: Building a Capital Markets Union (2015).

Corporate bond issuance (EUR bn)*

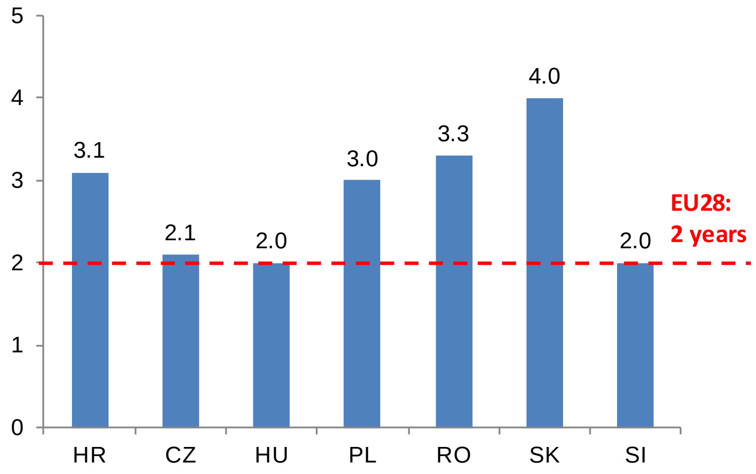


Bond issuance by countries (since 2009)

Source: Bloomberg, Erste Group Research, Note: Issued bonds at nominal above EUR 50m

Despite the recent pickup in bond issuance, bank credits still dominate corporate financing. In the long run, the capacity of the corporate sector in CEE to take on more debt in their balance sheet is much higher than in Western Europe, where the corporate debt level has likely reached its limit. However, the structure of the assets and liabilities of non-financial corporations in CEE reveals that delayed invoice payments have been extensively used in CEE as a cheaper way of borrowing compared to operational credits or overdrafts. They have been tolerated by creditors as the time for resolving insolvency averaged more than two years in CEE, which was a strong disincentive to creditors to take legal action against any company which opted to pay in delay.

Number of years to resolve insolvency

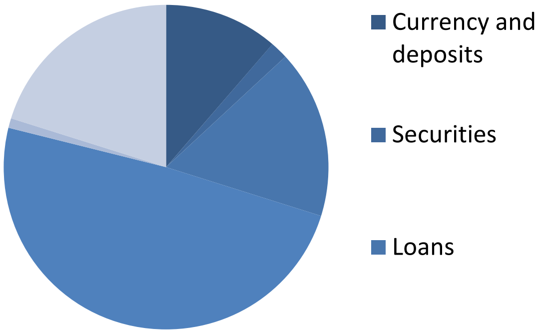


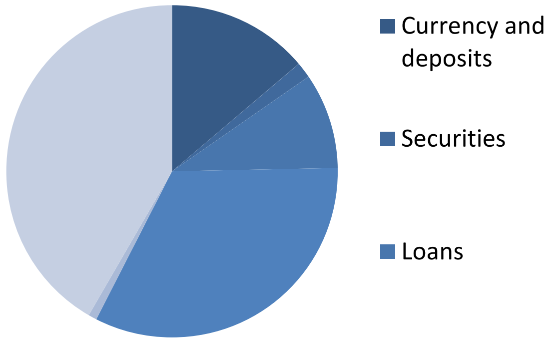
Source: Country SBA Fact Sheets, Erste Group Research

Fixing poor payment discipline could unlock greater potential for more investments

Releasing locked assets which companies (mainly SMEs) have in receivables (up to 41% of their assets in CEE vs. 20% in the euro area) through the imposition of stronger enforcement on payment discipline may allow for the redirection to more effective use of funds that are available for the financing of investment. Reduced uncertainty and increased financial transparency should also have a positive effect on investments. Poland has already realized the importance of this and has changed its Restructuring and Bankruptcy law in order to speed up the time in which creditors get paid and reinforce the rule of law.

Non-financial corporation assets structure in Eurozone (left) and in CEE (right)



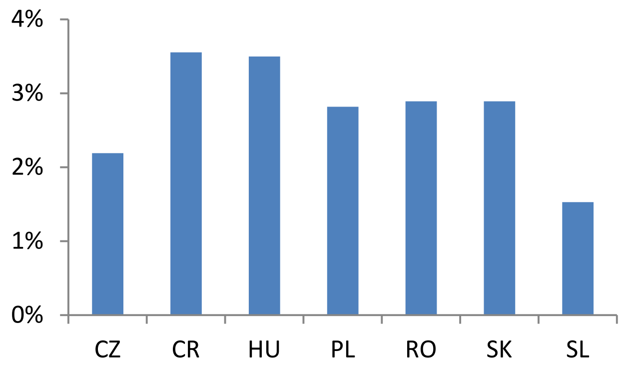


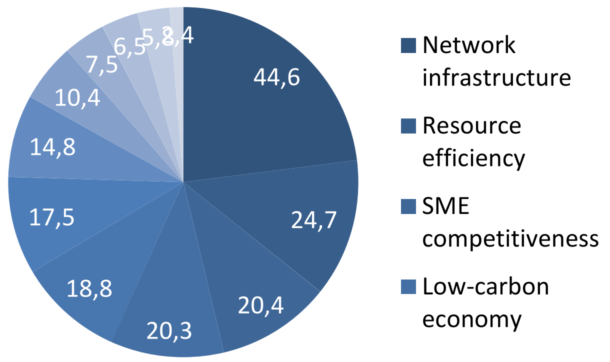
Source: ECB, Erste Group Research

EU funds to remain main source of funding for major investment projects in CEE region

In the upcoming few years, CEE countries should focus on taking advantage of the European Funds that are available in the current budgeting period. Available funds in the amount of an average annual inflow of 2% FY14 GDP should serve as the injection of capital needed to boost investment activity in the upcoming years. Investment in the transport and energy sector should have the highest priority, in our view. The greatest amount of funds is allocated for road and railway infrastructure projects (EUR 44.6bn), as well as for environmental projects aimed at improving the efficiency of resources. An efficient method for the utilization of EU funds should also take into account the long-term development perspective. Funds available for research projects or technological development should be utilized so as to enhance the transformation of CEE economies into more innovation-oriented economies.

European Funds allocation by country (annual flow, % of FY14 GDP) and by program (2014-20, EUR bn)





Source: European Commission, Erste Group Research

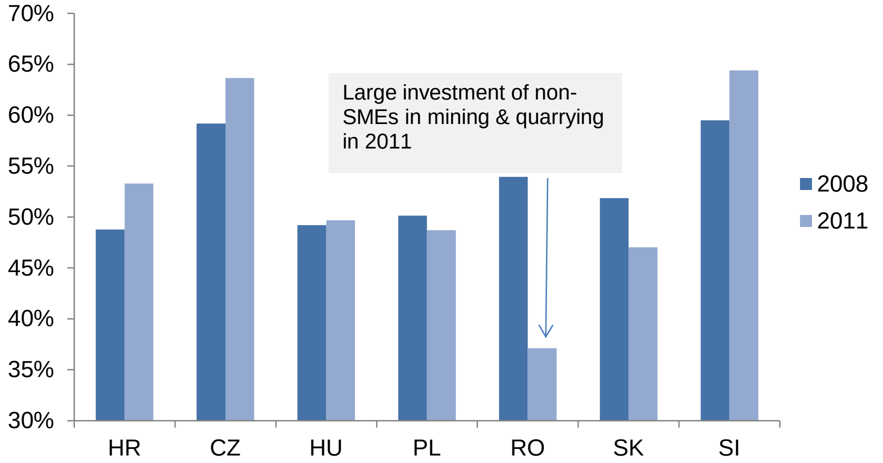
Case study: Importance of SME sector in restoring growth potential and boosting investments

Necessary but also worthwhile for SMEs to increase investments
Discussing the SME sector in terms of restoring the growth potential is important, given their importance in both value added and employment. SMEs (companies employing up to 250 people) account for 1/2-2/3 of value added and 2/3-3/4 in employment across CEE. The role of SMEs in CEE economies should even be increasing in terms of generating investments, as we have been observing a decline in net FDI inflow into CEE since the crisis, while the role of EU funds has increased. In this changed environment, it is increasingly important for SMEs to push their investments if CEE countries want to see a more marked turnaround employment and productivity growth. Low capital intensity creates the case for investments in the sector: as SMEs are more labor-intensive than the rest of the economy in CEE (and also compared to the rest of Europe), the return on capital can be larger, while wages in the SME sector also have the potential to increase with a higher capital stock in the long run.

Investment of SMEs less pro-cyclical than economy average

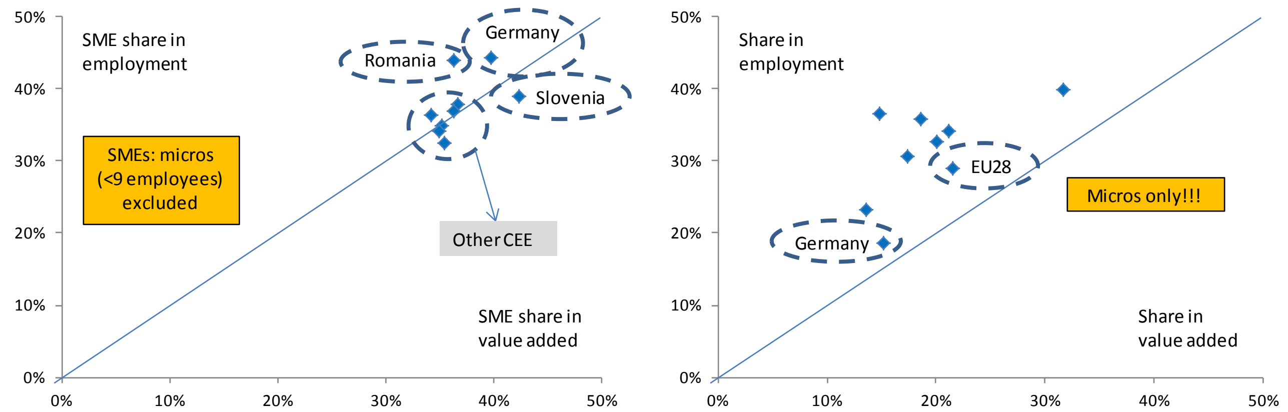
The effect of the crisis on the SME sector has been similar to that on the whole economy as far as investments are concerned. The fall in investments was more pronounced and general in all areas and in countries where the overall economic performance is also much weaker. However, for SME investments in general, the size of the drop in investments was smaller overall in the SME sector than in the whole economy. It seems that investments in the SME sector are mostly less pro-cyclical than in the whole economy. This also means, however, that the pickup in investments after the crisis was less pronounced for SMEs than for large companies. In terms of boosting SME investment, structural aspects of doing business are therefore more important.

Share of SMEs investments out of total investments, 2008 vs 2011



Source: Annual Report on European SMEs 2013/2014 – A Partial and Fragile Recovery (database), Erste Group Research

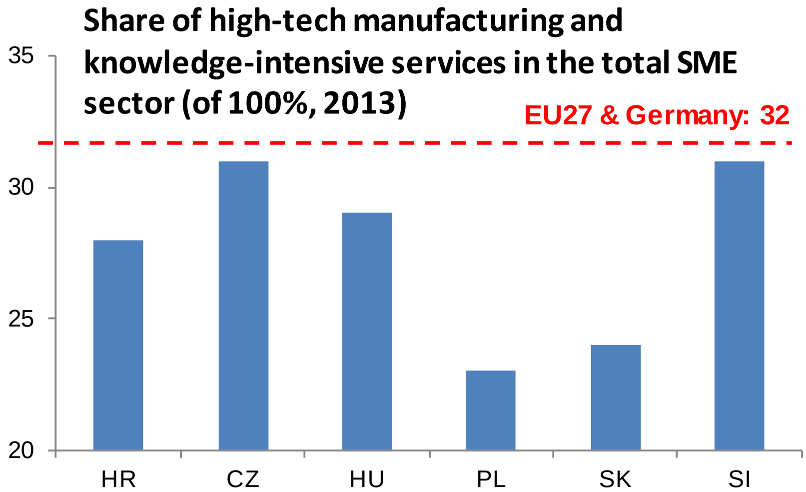
The secret of less cyclical SME investments lies behind the structure of SMEs. Excluding micro companies (0-9 employment), SMEs in CEE are largely as labor-intensive and produce as much value in the economy as Germany or the EU average. SMEs excluding micros produce roughly 35-40% of value added in the economy, which is accompanied by a similar share in employment as well. (The two relative outliers are Romania and Slovenia: in the former, SMEs excluding micros are still more labor-intensive than the EU average, while in Slovenia, SMEs are actually less labor-intensive than the economy average.) However, if we take a look only at the micro companies, it becomes obvious that in basically all CEE countries these companies are more labor-intensive than the EU average. If we compare them to Germany, the contrast is even larger: in the European economic powerhouse, micro companies employ nearly as (low) an amount of labor as their proportion of value added in the economy, while they also produce a not very substantial part of value added (around 15%). In most CEE countries, value added is also comparably small (figures below or around 20%, with the exception of Slovakia, which has a figure above 30%), but the employment level is much larger: typically higher than 30%. And, if the SME sector is more labor-intensive than the rest of the economy, then investments are also smaller at these enterprises. This means that they do not scale back investments as much as larger companies in absolute terms, but also do not start to invest so heavily when the upturn comes.



Source: Annual Report on European SMEs 2013/2014 – A Partial and Fragile Recovery (database), Erste Group Research

Labor-intensive micro companies have very large role in SME sector in CEE

If we take a look at the composition of the branches in the micro segment, we can conclude that it is difficult to pinpoint explicit branches that can be strongly blamed for this picture, with perhaps one (partial) exception: Slovakia and Poland show a very large significance of wholesale and retail trade (41% and 31%, respectively) within micros, while the role of this branch among micros is much smaller in Germany (20.5%) and in the EU (23%). However, in other CEE countries, the role of this branch is not too much higher than in the rest of the EU, so this is only a partial exception. If we take a look at the value added of SMEs compared to the German figure or the EU average in high-tech manufacturing and the knowledge intensive sectors, we also can see a gap to be filled (and the large role of the wholesale and retail sales sector might also be to blame for the poorer Slovak and Polish numbers). However, we cannot simply conclude that there is a general overweight of some sectors that needs to be adjusted in all CEE countries.



Source: Country SBA Fact Sheets, Erste Group Research

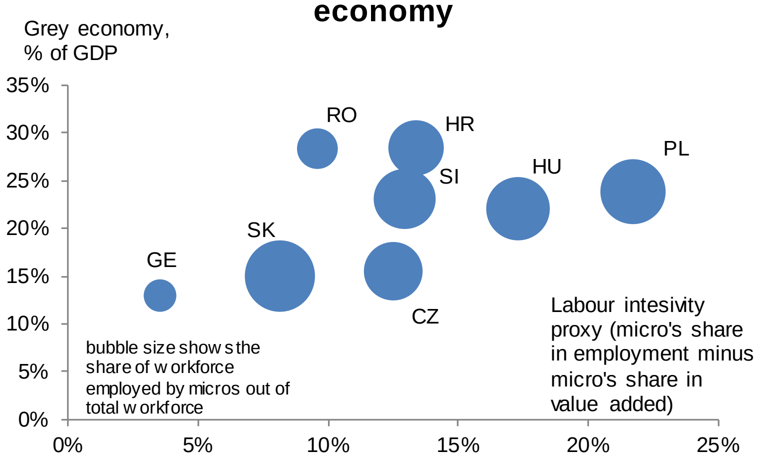
If small companies cannot grow to scale, that can hinder investments and growth

Overall, it seems that simply the large role of micro companies in general in CEE economies is (mostly) to blame, which amplifies the sector composition "problems" pinpointed above in some countries. This is problematic for multiple reasons. The large role of such small companies in the economy is certainly suboptimal if we think about economies of scale: the overall output of such an economic structure could be reproduced with a lower cost basis if companies grow to more efficient sizes. But efficient production on the part of these companies is not the only problem. Very small enterprises (like micros) can naturally have difficulties in finding financing: their level of capital (assets) is usually too small to borrow against, while it can be too risky for them to borrow if they are in an earlier stage of life. If they cannot borrow and invest, these companies also cannot grow and improve their product mix, which can also cause a decline in high-tech and knowledge-intensive value added, and can result in charts like the one above. Theoretically speaking, tax cuts and reductions in the administrative burden may not be enough to solve such problems, as these measures do not address this structural problem of the SME sector.

Larger size of shadow economy may explain higher number of people employed by micros

However, the important role of such small companies in the economy according to the statistics may be partly explained by that a significant number of these companies are sole proprietors, who are billing their company for their service but what they are actually doing is very similar to what a normal employee is doing. Investment from such 'companies' is naturally not expected, and can distort the figures. A potential cause for such a large role of micros and sole proprietors can be the informal economy and tax evasion: billing the company one is working for is a method to avoid social contributions, while sole proprietors can optimize taxes tied to employment. If we use the difference of the proportion of labor employed by micros and their value added as a proxy for labor intensity, and combine this with the level of employed and the level of the shadow economy, we can indeed conclude that the high role of micros can be attributed to the high level of the shadow economy:

Labour intensivity of micros, share in employment and total share of the grey economy



Source: Annual Report on European SMEs 2013/2014 – A Partial and Fragile Recovery (database), Size and Development of the Shadow Economy (Schneider, 2013) [4]*, Erste Group Research*

Access to credit relative strength of CEE, while challenges related to regulatory framework

Looking through the Doing Business rankings (which seems relevant for CEE government in their reform plans) for the business environment within Europe[5], CEE countries, as the youngest and least developed in the European club, naturally score worse than most western economies. Although the micro segment still sees access to financing as its main obstacle, the big picture shows that, compared to other European countries, access to credit is a relative strength of the CEE region, while the complicated regulatory framework, lengthy processes and nontransparent rule of law remain a major burden for business activity. Nevertheless, the business environment in Poland and Slovakia is no worse than that in France or Belgium and, among CEE; these two countries are the closest to the "European business frontier" set by Scandinavian countries. Further, Croatia and the Czech Republic offer better conditions for doing business than Greece and Italy. Even Romania, which scores the worst in the region, is ahead of Spain, which comes last. Although, according to our heat map of business conditions in Europe, there are still many challenges ahead of CEE region, governments have, however, made an effort to address major bottlenecks.

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[4] Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2013: A Further Decline (Friedrich Schneider, 2013, http://www.econ.jku.at/members/schneider/files/publications/2013/shadeceurope31_jan2013.pdf, accessed: 12.5.2015)

[5] We use the scores from Doing Business ranking 2014 in the following categories, Staring Business, Construction Permits, Getting Electricity, Registering Property, Getting Credit, Enforcing Contracts, Paying taxes, to determine the relative position of European countries to one another. Keeping the methodology of Doing Business ranking, we recalculate positions limiting ourselves to Europe only.

Heat map of business conditions in Europe

Source: Doing Business ranking, World Bank, Erste Group Research

What issues should policymakers address to foster SME investment?

As FDI financing has been losing ground since the crisis and EU funds have increased their share, it is very important for SMEs to increase their investments for the CEE region. Low capital intensity creates the case for investments in the sector: as SMEs are more labor-intensive than the rest of the economy in CEE (and also compared to the rest of Europe) the return on capital can be larger, while wages in the SME sector also have the potential to increase, with higher capital stock in the long run. However, the above obstacles need to be tackled to unlock the investment potential from SMEs. Removing the obstacles that prevent the growth of micro companies to reach scale is required; in the meantime, it seems that the shadow economy is also important in explaining the large role of micro companies. Beyond these, the complicated regulatory framework, lengthy processes and nontransparent rule of law remain a major burden for business activity, as the Doing Business ranking shows. The lengthy processes to resolve insolvency and long payment delay times (which puts small enterprises in an especially difficult position given their smaller capacity to finance their business partners in this manner) should be addressed in order to create a healthier SME sector that is more willing and able to carry out investments in the future.

What has been done so far by governments to enhance private investment?

Croatia

The major bottlenecks in Croatia are structural issues such as the lack of a stable legal environment, high administrative burdens, discriminatory practices and red tape. Although there are some developments regarding the bureaucratic burden (bankruptcy and insolvency procedures), Croatia still scores poorly in such categories as construction permits, getting electricity or registering property. The Croatian government addressed some bottlenecks by adopting The Act on Investment Promotion and Enhancement of Investment Environment or The Act on Strategic Projects and Legislation that aims at offering various financial and administrative incentives for foreign and domestic investors. Moreover, there have been adjustments to the labor law that made it easier to implement flexible working times and terminate some categories of collective agreements.

Czech Republic

In spite of recent efforts to address the challenges related to an underdeveloped public infrastructure, procedures for issuing construction permits remain lengthy and investors still need to cope with inefficiencies in public procurement or delays related to decisions issued by the anti-monopoly office. The high number of regulated professions (actually the highest in the European Union, according to the European Commission) should also become part of the reforms' agenda. Progress has already been made in simplifying the process of setting up a company, which has been a major bottleneck for investors. Moreover, the Czech government approved an amendment to the law on investment incentives, which enables the establishment of special industrial zones (SIZ) that offer special incentives for investors (e.g. CZK 300,000 per newly created job and five years of real estate tax exemption). In our view, the government should further focus on promoting more intensive usage of e-government services (currently far below the EU average, at 13.7 % in the Czech Republic vs. 33% in Europe). As befits the most advanced economy among CEE, the Czech Republic is also advised to increase its R&D spending further so that it does not lag behind in terms of scientific and technological results.

Hungary

As for Hungary, an often cited bottleneck that should be tackled to improve the business environment is the predictability of government policymaking and the regulatory framework. With this regard, we think that the government took steps in the right direction by announcing the plan of reducing several sectorial taxes, such as banking tax and tax levied on the telecommunication sector. In addition, the government signed a memorandum with the EBRD in which it commits itself to creating more market-friendly regulation. We think perhaps more could be done with terminating restrictions and abolishing barriers to entry to certain markets (such as tobacco retail, pharmacies, textbook publishing and distribution, waste management, etc.) as well as fostering market competition. Given that the region will be less and less able to compete just by low wages in the future, Hungary should perhaps reallocate public spending to healthcare and education also. We think there is some room to do this, as Hungary has the second largest public expenditure as a percent of GDP (46%, excluding interest payments) after Slovenia in the CEE region, but according to most recent OECD statistics, the state still spends just 5% of GDP on healthcare (OECD average is 6.7%). In terms of non-tertiary education, spending went down from 2005 by more than 20% by 2011, according to OECD, which could and should be improved.

Poland

Lengthy procedures related to setting up a business, contract enforcement, construction permits or registering property are among the biggest challenges for the business environment in Poland. A complicated regulatory framework and ambiguous interpretation of the letter of the law are examples of common obstacles that the SME sector has been facing in their everyday operation. Some of these issues have been addressed lately. First of all, Poland substantially shortened the time needed to set up a firm (from 25 to 7 days) and reduced the waiting time for some types of construction permits. Moreover, the effectiveness of enforcement proceedings should increase as a result of new legislative measures in that area. Further, a government-amended bankruptcy law that introduces new restructuring procedures should allow SMEs to cope with financial problems and avoid liquidation at the same time. More attention should be paid to the digitization of public administration, as using e-services in Poland remains at the lowest level among all EU countries.

Slovakia

Although business conditions in Slovakia are better compared to most of its regional peers, further reduction of regulations would be desirable. In particular, the time and cost of issuing licenses and construction permits should decrease, and the average duration of bankruptcy procedures (currently the longest in the EU) should be visibly reduced. That would automatically lead to higher quality of administration and the next step – development of e-government services – could follow. The government has already moved in that direction by introducing electronic filing for VAT. That, together with a simplified registration process for SMEs through the reduction of the time needed to register with district courts and elimination of the need for signature verification by a public notary, made starting a business much easier. Further, Slovak Investment Holding (SIH) was created recently, in order to help administer pro-growth measures aimed at supporting long-term investment from European funds.

Romania

In order to become more attractive for investors, Romania should develop high-quality infrastructure in the first place, as the low quality of its roads, railway, and electricity supply is a major obstacle when it comes to investment decisions. As far as other aspects of business environment are concerned, Romania should improve its regulatory framework and deal with such issues as construction permits, registering property, getting electricity and enforcing contracts. Lengthy and nontransparent legal processes are a source of major uncertainty and risks for running a business in Romania. Moreover, the government should improve administrative procedures related to public procurement or the drawing of EU funds. Full use of EU funds still remains one of the main challenges facing Romania. So far, Romania has managed to absorb only half of the European Structural Funds allocated for 2007-13, while progress in implementing structural reforms is slow.

Slovenia

As opposed to other countries in the region, the biggest bottleneck for Slovenia is access to financing. As bank lending activity has been declining, it has been relatively difficult to get credit in Slovenia compared to other CEE countries (Slovenia scores poorly in this respect, despite the fact that the category is an obvious strength of the CEE region) and finance investment in the SME sector. Further, the relatively high degree of sectorial regulations (including access to some professions) has an adverse impact on competitiveness due to high entry barriers. In our view, Slovenia has also made limited progress regarding the promotion of FDI, given that it plays an important role as a long-term, stable source of financing for the economy. In order to reduce the burden, Slovenia took several measures, among which, the so-called one-stop-shop has been supporting entrepreneurs in setting up their businesses. Moreover, the use of e-government services has increased. The government has identified several measures to cut red tape by 25% and improve the legislative and business environment, with a key tool being the Single document (this lists measures in 16 different areas to reduce the administrative burden, with implementation currently broadly on track). In addition, Slovenia plans to introduce "competitiveness proofing" and the ‘'SME Test" in order to make future laws and regulations more business-friendly

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