# Investment: Moving the Productivity Frontier - Conference Report

## Introduction

The conference was organized jointly by the Croatian National Bank (CNB) and the European Investment Bank (EIB). It was held on 7 March 2018 at the premises of the CNB. The conference was an opportunity for various stakeholders to share their views on the role of investment in Croatia and identify barriers that need to be removed in order to encourage productive investment and thus raise potential output growth. The discussions also touched upon the important role played by the European structural and investment funds, and the EIB. Many distinguished speakers took part in the discussions, including government officials, central bank board members, high-level representatives of EU institutions and international financial institutions and members of the domestic business community.

## Key outcomes

The Croatian economy is currently in its fourth consecutive year of recovery after a six-years-long recession. Although economic activity has strengthened and macroeconomic imbalances receded, Croatia still lags behind its peers according to estimated potential output. The challenge is how to unlock Croatia's growth potential and thus allow for a more rapid income convergence. Upscaling potential output prospects is the challenge for Croatia and it requires a complex set of policies, tackling all the components affecting potential growth: capital, labour and productivity.

Investments are seen by many as a key ingredient to success. The level of investment in Croatia has plummeted during the crisis and it is now similar to investment levels seen in advanced Member States. Such level of investment might be insufficient for a catching-up economy. However, most speakers argued that Croatia's low potential output is rather driven, by weak total factor productivity growth and low labour utilisation. Therefore, policy measures should be designed in a way to encourage productive investment, especially those that are innovation-intensive. The fact that investment activity is subdued compared to the pre-crisis period is partly a result of the sharp reduction in housing investment during the crisis, following several years

of a housing market boom. At the same time, investment in manufacturing has barely declined during the recession.

Many speakers stressed the importance of investment in intangibles. While investment in physical capital is generally perceived as the primary form of investment, intangibles – such as software, R&D and professional training – have gained a prominent role in line with the technological progress. Croatia underperforms according to the level of spending on intangibles. One of the factors behind this is limited access of innovative firms to external financing. While physical assets such as buildings and vehicles can easily be used as collateral for bank funding, this is not the case with intangibles. In such context, innovative firms have to use their own funds or rely on scarce venture capital.

Several obstacles and potential remedies were identified:

- The uncertainty regarding the regulatory environment continues to be a drag on investment. Therefore, many speakers stressed the need for further simplification of product and labour market regulation and improving the efficiency of the public sector, in particular judiciary. Fiscal consolidation is on track, but further attention should be paid to tackling the long-standing problems in the pension and health care system. Consistent implementation of reforms is of crucial importance to Croatia also to reach its strategic medium term goal – adopting the euro.

- Absorption capacities need to be upgraded further in order to take full advantage of the European structural and investment funds. The amount of funds allocated to Croatia within the financial framework 2014-2020 exceeds 3% of GDP on an annual basis. The economy will benefit greatly if most of these resources are absorbed and used for productive purposes. The EIB will continue to provide considerable support to Croatia's economy both directly, through the financing of large infrastructure projects, and indirectly by extending long-term loans to the state development bank HBOR and the commercial banks.

- Limited availability of skilled workers has become a major issue for many Croatian companies. It reflects a pronounced mismatch between the needs of the business sector and the skills of the labour force. This calls for enhanced rethinking of the education and professional training system.

- While non-financial companies' access to external financing has improved in the context of favourable macroeconomic developments and supportive monetary policy, the percentage of companies that report to be credit constrained is higher than the EU average. This is partly related to the debt overhang in the corporate sector, as a large share of the total debt is concentrated in the segment of highly indebted corporations that have limited debt-servicing capacity. These companies need a comprehensive financial and operational restructuring to become sustainable. At the same time, with a very much bank-based system, there is a need for more innovation finance. This calls for policies to deepen the financial sector and allow for a diversification of available resources.

## Opening

In his opening remarks, **Mr. Boris Vujčić**, Governor of the CNB, set the stage for discussions by explaining the broader macroeconomic context. Governor Vujčić stressed that the Croatian

economy is going through a solid, broad-based recovery supported by strong export performance. In the context of the robust recovery and prudent economic policy, macroeconomic imbalances have been receding. Croatia is now registering sizeable current account surpluses, while the external and government debt have been on firm downward trajectories. Owing to improved fundamentals, Croatia's credit rating was upgraded, while the Excessive Deficit Procedure was closed. Despite this, he noted, a number of structural weaknesses remain. In particular, the still subdued investment and unfavourable demographic trends combined with weak productivity growth result in a relatively low potential growth. In order to encourage investment and raise the potential growth, further ambitious efforts should be made to improve market functioning, simplify business regulation, strengthen the legal framework and improve the outcomes of the education system.


Following Governor Vujčić's address, **Mr. Dario Scannapieco**, Vice-President of the EIB, briefly commented on the findings of a recent EIB survey. He noted that according to the data on investment activity Croatia stands favourably compared to other Member States. The survey has shown that Croatian companies have stepped-up their investments in physical capital, mostly with the purpose of expanding capacities. Investments in intangibles, on the other hand, have been much less buoyant. Mr. Scannapieco pointed out that Croatia has to take advantage of the favourable years following the EU accession to strengthen its competitiveness. Increasing the investment in intangibles is one of the key steps that have to be taken to achieve that goal. Most firms singled out the limited availability of skilled labor force as one of the largest constraints to investment, together with uncertainty, energy costs and complex business and labor market regulations. He added that the survey reveals that Croatian companies are more likely to be credit constrained than companies in other Member States. In order to move up the value chain, the Croatian economy would benefit from further investment in skills and education, improving business environment, financing support of innovative SMEs, as well as boosting ICT infrastructure. More diversification of financing sources, particularly to support innovative firms, would be beneficial in Croatia.

Mr. Scannapieco concluded by saying that the EIB Investment Survey, provides the EU Bank with a powerful policy tool for understanding how the EIB can bring real value added for companies across Europe and EIB will continue to support the convergence of the Croatian economy.

At the end of the opening session, **Ms Martina Dalić**, Deputy Prime Minister and Minister of Economy, Entrepreneurship and

Crafts, described the policy measures that the Government has taken in order to improve the investment climate in Croatia. In that regard, she mentioned that the recent tax reform, which led to the lowering of the overall tax burden, has shown encouraging results. In addition, measures were taken to simplify administration, while new legal acts were adopted to promote investment and R&D spending. Ms Dalić noted that the Government's key priorities for the near future are increasing the effectiveness of public institutions, raising the utilization of EU funds and improving the business environment. With regard to the business environment, special attention will be given to addressing the backlogs in the judiciary and strengthening the outcomes of the education system.

**Session I: The Investment–Economic Growth Nexus in Croatia**

The moderator of this session was Mr. Gordi Sušić, Director at the Croatian National Bank. The session began with three presentations, delivered by Ms Debora Revoltella, Director at the EIB, Mr. Vedran Šošić, Vice-governor of the CNB, and Mr. Servaas Deroose, Deputy Director-General of the European Commission's DG ECFIN.

**Ms Debora Revoltella** presented, in more detail, the results of the EIB's investment survey, which Mr. Scannapieco briefly summarized in his opening address. Investment activity in Croatia is picking up, both in the private and the public sector. Level of investment is comparable to those in the advanced Member States, and probably too low for a catching-up economy. The scale of public investment is constrained by the fiscal consolidation efforts. During the prolonged recession, a re-prioritisation of current expenditure at the cost of reduced capital expenditure led to a growth unfriendly consolidation pattern. The fiscal consolidation is still ongoing and hence there is a limited room for a considerable increase in capital expenditures. Therefore, a successful utilization of EU funds may provide a crucial impetus to public sector investment in Croatia. The absorption capacity has increased, but further actions are required in this area. Private sector investment has strengthened and the outlook is favourable, although companies report to be burdened by some cyclical and structural issues. Given that the availability of skilled workers is considered to be one of the main structural issues, Croatian firms believe that government should channel more resources into professional training and higher education. Other key areas for public investment according to Croatian firms are the ICT and the transport infrastructure.
The EIBIS shows the importance of the business environment and the need to focus more on enhancing the innovation capacity of firms. More than one in five firms in Croatia believe they

invested too little in the last three years, a higher share than on EU level. EIBIS also reveals that firms with too little investment rank their capital stock to be of lower quality – implicitly signalling investment backlog. The innovativeness profile of Croatian companies shows that they have an innovation focus, but mostly they rely on adoption rather than developing. Firms in Croatia mostly invest in tangibles while investment in intangibles is considerably below the EU level (23% compared to the 37% of total investment). Moreover, although access to finance is not anymore the major obstacle to invest, about thirteen percent of firms face finance constraints, which is above EU average, and reliance on internal financing sources remains high. Access to finance is a more stringent issue in Croatia compared to other EU countries and small and innovative firms face even greater difficulties to successfully tap external financing as they lack the requested collaterals or they find the borrowing costs too expansive.

**Mr. Vedran Šošić** confirmed that public sector investment dropped considerably during the crisis. In the pre-crisis period, Croatia was an outlier among peer countries with a very high level of public investment, while today the relative size of public investment is the lowest in the peer group. Investments in the private sector have shrunk as well and remain below pre-crisis levels. However, the relatively low level of investment is probably not to the major cause of the low potential growth. Part of the overall decline in investment was a correction of excess capacities in the non-tradable sectors which built-up during the pre-crisis expansion. Investments in the manufacturing, on the other hand, have barely declined during the crisis, and this sector has been the main driver of the recent recovery in investment. Furthermore, Mr. Šošić said that a survey conducted by the CNB has shown that firms rely mostly on their own resources to finance investment, despite the improved access to external sources of financing. At the same time, several large and highly indebted companies continue to be credit constrained. These companies require comprehensive financial and operational restructuring to become sustainable. The CNB's survey results confirm the findings of the EIB that the lack of skilled staff has become one of the biggest structural obstacles to business in Croatia.

**Mr. Servaas Deroose** acknowledged Croatia's progress in maintaining economic recovery and reducing macroeconomic imbalances. Employment growth has been strong, while real output is expected to finally reach the pre-crisis level next year.

However, Croatia lags behind its peers with regard to potential output growth. Mr Deroose stressed that the level of investment is not a restraining factor for Croatia, given that capital accumulation is comparable to those in peer countries. The main obstacles to potential growth stem from low utilization of labor and weak productivity growth. In such context, Croatia needs to engage in reforms that aim at increasing labor market participation, improving the business climate and raising the efficiency of public spending. Until now, Croatia has achieved only limited progress in the implementation of such reforms. Much more attention has to be devoted to structural reforms in order to unlock Croatia's growth potential. These reforms are important also in the context of Croatia's ambition to adopt the euro. Croatia need to speed up considerably in terms of public procurement/PPP, public wage settings and sector-specific regulations (digital/telecom, energy and transport sectors and business services).

In the panel discussion that followed, Ms Paloma Lopez-Garcia from the ECB stressed that in order to understand whether the investment level was currently too low, and why, it was important to go granular and explore which firms, and in what sectors, were currently underinvesting. According to CompNet data, the largest reduction in investment relative to the pre-crisis period had taken place in construction, which was not necessarily bad. However, a cause of concern is that to some extent across all sectors both low and high productive firms had reduced their investment in Croatia. Based on her studies, she noted that insufficient supply of skilled labor is especially challenging for highly productive firms, such as those from the manufacturing and IT. In addition, highly productive firms are often credit constrained, especially when trying to obtain funding for investment in intangibles. The problem is that intangibles, in contrast to physical assets, are rarely used as collateral in bank lending. Nurturing the development of alternative, non-bank financing sources would reflect positively on such firms. In that regard, **Ms Debora Revoltella** said that the EIB has been fostering the development of non-bank financing markets by lending to investment funds that act as venture capital providers and private equity investors. **Mr. Dubravko Mihaljek** from the BIS discussed the outlook for cross-border capital flows and their potential role in supporting investment in Croatia. He explained that capital inflows have decelerated due to both cyclical and structural reasons. The lower scale of inflows is not necessarily a bad thing given that a large part of the sizeable inflows in the pre-crisis period was channelled to sectors such as the construction and real-estate. Mr. Mihaljek emphasized that the export-oriented growth model to avoid the “middle income trap”, which was pursued by some new Member States, is not the only viable growth model for Croatia. Much can be achieved by creating a business-friendly environment, in particular by resolving remaining issues in the education, public administration and judiciary system. Responding to the question on the Investment Plan for Europe, **Mr. Servaas Deroose** noted that the implementation of the Plan is well on track, with more than 80 percent of the initially envisaged EUR 315 billion of investments already realized. He stressed

that the private sector has generated a large part of the overall investment activity under the Plan.

**Session II: Investments in Real Life**

This session was organized as a panel discussion with the participation of Mr. Miguel Morgado, Director at the EIB, and representatives of the private sector. The moderator of the session was Mr. Anton Kovačev, Head of the EIB's Zagreb Office.

**Mr. Miguel Morgado** agreed with the main conclusions of the first session. Croatian firms have become more optimistic about the economic outlook, which is reflected in the more buoyant investment activity. Most of them are investing in order to expand capacities, while innovation has not been a major motive for investment. He stressed that Croatian firms need to preserve their competitiveness, especially those that are export-oriented. In practice, that implies that remuneration of production factors should evolve in line with their productivity. In addition, Mr. Morgado provided a brief overview of the activities of the EIB in Croatia. Over the past 10 years, the EIB has provided funding totaling EUR 4.6 billion to support investment in Croatia, with annual funding of 1.2% of the country's GDP in 2017 that places Croatia on the third position among the EU Member States. Although the EIB is primarily involved in large infrastructure projects, it indirectly supports smaller businesses by ensuring long-term funding at competitive terms to the state development bank HBOR and commercial banks.


In the remainder of the session, representatives of the business community commented on their own experiences with conducting investment in Croatia. **Mr. Darko Ranogajec**, President and CEO of OMCO Croatia, pointed out that investing in modern technologies and human capital is the only way to achieve and preserve competitiveness. With the right technology and skills, Croatian firms can compete even with foreign competitors that rely on low labor costs. **Ms Marija Tufekčić**, Executive Director of Plavi Partner d.o.o., noted that access to European structural and investment funds, with the size of the allocated funds exceeding 3% of GDP annually, represents a tremendous opportunity for Croatian firms. The access to EU funds has even led to higher efficiency of the public administration, as many government units have been working hard to utilize the resources allocated to Croatia. Some of the panelists experienced first-hand the positive effects of the EU funds on investment and job creation. **Ms Jasmina Dovgan**, Board Member of Signalinea d.o.o., explained how a successful utilization of EU funds has allowed her company to expand capacities and hire additonal workers. On the other hand, **Mr Jacques Ferron**, President of Zagreb Airport, explained how private and public sector funding, including the loan from the EIB, could be successfully blended to produce a large infrastructure project.

**Closing**


**Mr. Zdravko Marić**, Minister of Finance of the Republic of Croatia, closed the meeting by reiterating several key messages of the conference. The Croatian economy is experiencing a firm, broad-based recovery, supported by a gradual pick-up in investment. However, the real GDP is estimated to be growing above potential. Hence, the main challenge for the policymakers is finding a way to boost the potential output growth so that Croatia continues its convergence process. In that regard, Mr. Marić said that the Government is committed to creating a more business-friendly regulatory environment, strengthening the human capital and improving the utilization of EU funds. All this should

encourage productive investment, increase the potential output growth and allow for a more rapid income convergence.

Reported by Rozalia Pal (EIB) and Mislav Brkić (HNB), 19 March 2018.