European financial landscape and access to finance

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Highlights

- What limits new investment opportunities?
- What can increase the financial resilience of corporates?
- What can incentivise firms to hold more equity?
- Debt versus equity capital flows
What limits new investment opportunities?

- **Financing constraints** – no longer a major obstacle to corporate investment growth

- **Deleveraging pressures** – abating, but legacies from past excessive leverage and zombie lending still exist

- **Structural conditions** – institutional and regulatory frameworks and business environment become a growing concern
Access to finance gradually improves...

Percentage of SMEs responding that their most pressing problem is access to finance (SAFE)

Financing sources gradually diversify – case of Croatia

Source: ECB, Bendel et al. (2017)

... and deleveraging pressures have abated, but a firm-level look reveals remaining vulnerabilities.

Corporate debt, as % of GDP

Debt overhang in Croatia concentrated in large, non-exporting, foreign-owned firms, mostly in the construction sector

Source: Eurostat

Source: Martinis and Ljubaj (2017), data obtained from FINA.
Prevalence of zombies limits resource reallocation to and investment in non-zombies

The share of zombie firms was increasing and productivity gap widening

Potential gains from reducing the zombie capital share to the sample minimum, 2013

Corporate leverage is one of the main determinant of corporate resilience.

Leverage ratio varies between member states.
What can increase the financial resilience of corporates? (2)

- Fixed assets mainly financed by the bank loans
  - a burden to financial statements
  - increases credit riskiness of companies

- The higher trade receivables, the higher trade payables
- Late collection or inability to collect receivables increases exposure to liquidity and credit risk of corporates
- Each year across EU thousands of SME’s go bankrupt because of cash flow disruptions induced by late payments

* Due to data unavailability for 2015, CZ & SK as at 2014 and 2013 respectively

Source: ECCBSO BACH database, FINA
Financial resilience of corporates can be increased by implementation of active and mandatory risk management based on the role model implemented in financial sector.

IFRS 9 is a step in right direction, but it’s effects and the scope of its application is yet to be seen in the future. It might increase capital reserves/provisions and impairments for financial instruments (mostly trade receivables) by recognizing potential losses, lowering corporate’s sensitivity to future volatilities of instruments values and returns. It might discourage "shadow banking" as well.

High share of fixed assets (particularly tangible) in total assets is mainly financed by bank loans and is a burden to P&L and flexibility of business. Further developments in real estate lease market would increase flexibility and movability of business and consequently increase financial resilience of corporates.
What can increase the financial resilience of corporates? (4)

- Trade credits play significant role in company’s financing (each of trade receivables and trade payables make between 10-20% of total assets in most of EU countries)

- Reinforcing of financial discipline would increase short term liquidity and decrease days sales outstanding (DSO) and days payable outstanding (DPO), resulting in reduction of trade credit balance (TCB)

  - Large firms in many EU countries are more likely to find financing through the trade credit channel* using it as interest rate free „revolving-like” funding source

\* weighted means; analysys includes manufacturing, construction and trade
What can incentivise firms to hold more equity?

- **Doing business 2018: Ease of enforcing contracts vs. Leverage in 2015**
  - Increase of equity reduces financial leverage
  - Legal security increases usage of external financing
  - Still, other instruments could incentivise companies to hold more equity:
    - Retaining profits could be encouraged by taxation policy (retained profit converted to equity is non-taxable, like in i.e. HR)

Source: ECCBSO BACH database, FINA, WB Doing business EU 2018
More equity financing availability needed to support development of innovative firms

Note: Group ranking weighted by countries’ GDPs.
Source: Global Competitiveness Report 2016–2017
Debt versus equity capital flows

- Foreign capital inflows - potential positive effects as well as negative consequences

- Macroeconomic effects of capital flows depend on their structure (FDIs that are relatively more oriented towards tradable sector, lead to productivity enhancements and are less volatile, while real exchange rate appreciation is mainly due to debt inflows), with risks for financial stability stemming more from debt flows (particularly from those financing household debt boom)

- FDI inflows to CEE region are below pre-crisis levels, even looking at a longer period average, implying lower potential positive spillover effects

- Scarce capital flows emphasize the importance of efficient resource allocation, especially capital allocation, towards the more productive firms
Thank you!