BUSINESS RESILIENCE IN THE PANDEMIC AND BEYOND

Adaptation, innovation, financing and climate action from Eastern Europe to Central Asia

Executive summary

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European Investment Bank
The EU bank

Business resilience in the pandemic and beyond: Adaptation, innovation, financing and climate action from Eastern Europe to Central Asia
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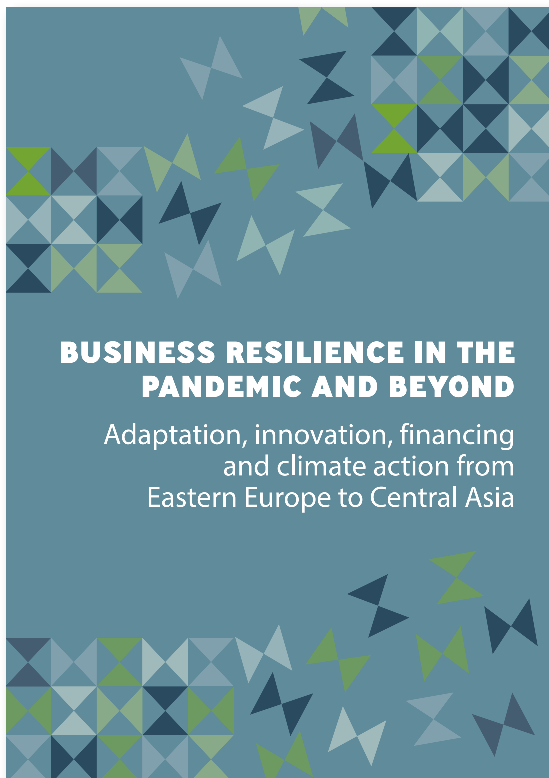

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Executive summary

The COVID-19 pandemic led to a sharp contraction in economic activity in Eastern Europe and Central Asia.[1] On average, GDP in the region declined by 4% in 2020, with enterprises in contact-intensive service sectors being especially hard-hit. But the policy support was unprecedented, with fiscal measures amounting to around 6% of GDP. Thanks to this support, to date, corporate bankruptcies have remained limited, job losses contained and private sector balance sheets protected.

The resilience of firms in the initial stages of the pandemic is a testament to the importance of productivity gains, innovativeness, managerial quality, global integration and access to finance. To strengthen future resilience, firms will need to keep improving in these areas, as well as adapting to longer-term changes, such as global warming and shifting global value chains (GVCs). Supportive government policies, regulations, investments in key sectors, such as green and digital infrastructure, and continued development of the financial sector could all play important complementary roles.

The war in Ukraine once again changes this landscape. The loss of human lives in Ukraine and a massive humanitarian refugee crisis in Europe, combined with major physical disruptions to trade, the united response from a large part of the international community and the sanctions on Russia and Belarus, signal a reshaped geopolitical context and a turning point for the region. Economic consequences will be severe, and not only for those countries directly involved in the conflict or directly affected by sanctions. These effects will once again test firms' resilience and ability to adapt. Structural features characterising the business environment will continue to play a role in defining firms' capacity to transform.

Global value chains have contributed to defining the growth model for the region and have remained resilient to date. During the pandemic, firms in the region benefited from policy support, combined with credit and intra-group funding. The ability to draw on intra-group funding was an additional life-saving form of support. The growth of trade and the expansion of GVCs have been important drivers of economic development, especially in Eastern Europe and Central Asia. But the COVID-19 crisis disrupted economic activity across the globe, with global merchandise trade decreasing by 7% in 2020. While GVCs have remained resilient, many pandemic-induced mismatches of demand and supply have emerged during the recovery phase and have been transmitted globally via trade. These may lead to long-term effects on international trade and the organisation of GVCs. Firms' profitability, competitiveness and survival depend on cross-border trade, foreign direct investment (FDI), the availability (or migration) of skilled workers, and international flows of research and development (R&D) and innovation. The analysis presented in the report shows that export and global value chains have a causal effect on firms' innovation capacity in the region, through better management and the transfer of technology. The European Union thus emerges as a trade facilitator and a driver of innovation.

Looking beyond the COVID-19 crisis, global warming remains one of the major challenges of our time, and the region still lags in terms of the transition toward a low-carbon economy. Global warming is manifested in long-term changes in weather patterns, including rising sea levels and frequent extreme weather events. The Intergovernmental Panel on Climate Change has warned that only a few years remain to decarbonise economies radically if disastrous global warming is to be avoided. Business models will need to adapt and build around the economics of low-carbon emissions to mitigate potential losses from their exposure to physical and transition risks. At the start of its economic transition from central planning to market-based economies, the region was an outlier relative to countries with similar levels of development in terms of carbon emissions per capita. Since the 1990s, carbon emissions have decreased substantially. But despite a shift away from coal and oil towards nuclear power and renewables, the region still relied on fossil fuels to generate three-quarters of its electricity in 2018. Moreover, several countries continue to provide generous fossil fuel subsidies, thus slowing down decarbonisation.

1 The region of Eastern Europe and Central Asia is made up of several sub-regions: Central Asia (CA), comprising Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan and Uzbekistan; Central and Eastern Europe (CEE), comprising Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia; the Eastern Neighbourhood (EN), comprising Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine; Russia (RUS); Turkey (TUR); and the Western Balkans (WB), comprising Albania, Kosovo, Montenegro, the Republic of North Macedonia and Serbia.

To date, financial systems in the region have held up. But they remain biased towards bank lending, with only a limited role for equity markets and with signs of mismatch between demand and supply. While financial sectors across the region are at different stages of development, most remain bank-based. Bank credit is still by far the most important source of external finance for many firms, including small and medium-sized enterprises (SMEs). Alternative sources of finance are scarce. Capital markets remain underdeveloped and the availability of venture capital, private equity and leasing is very limited. In Central and Eastern Europe and the Western Balkans, foreign banks entered the market, bringing new banking practices and capital, and funding relatively fast, mostly foreign exchange-based, credit growth. But the global financial crisis of 2007-09 triggered a rebalancing, with more focus on domestically funded, and thus more moderate, growth. Similar paths have been followed in Turkey, Russia and Kazakhstan. In those countries, boom-bust phases have been somewhat more pronounced, while foreign banks were competing with domestic, often state-controlled banks. In the Eastern Neighbourhood and Central Asia, the transformation of the banking systems has been somewhat slower, resulting in lower levels of financial development.

I.I. The EBRD-EIB-WBG Enterprise Survey: providing an in-depth perspective on firms and the obstacles in their business environment

This report uses a unique firm-level dataset. Specifically, it analyses data from the latest wave of the EBRD-EIB-WBG Enterprise Survey (ES 2019), which collected data on more than 28 000 formal (registered) firms between 2018 and 2020. The survey was conducted just before the outbreak of the pandemic, providing a structural snapshot of firms in the region. The report also uses the first round of the COVID-19 Follow-up Enterprise Surveys (covering more than 16 000 firms), carried out by the World Bank to illustrate how firms have reacted and adapted during the crisis. The ES 2019 and the follow-up COVID-19 module (COV-ES) include a sample of countries in Southern Europe (SE), which are employed as a comparator group; the other comparators are firms in the lower-middle-income (LMI) and upper-middle-income (UMI) countries.[2] All statistics for regional aggregates are reported as simple averages of individual countries, whereby firms within countries are weighted with survey weights.

The Enterprise Survey provides a rich source of information about firms and their business environment. The questionnaire includes firm characteristics, annual sales, costs of labour and other inputs, performance measures, access to finance, workforce composition and participation in the labour market. There is also a special module on the green economy. The survey provides a representative sample of the non-agricultural, formal private sector for firms with at least five employees and operating in the manufacturing or services sectors.[3] The survey uses random sampling, stratified by firm size, sector of activity and regional location within each economy. Stratification ensures that there are enough observations for robust analysis within each stratum. The survey design, comprehensive sample frames and sampling weights together ensure that the surveys are statistically representative of the private sector in each economy.

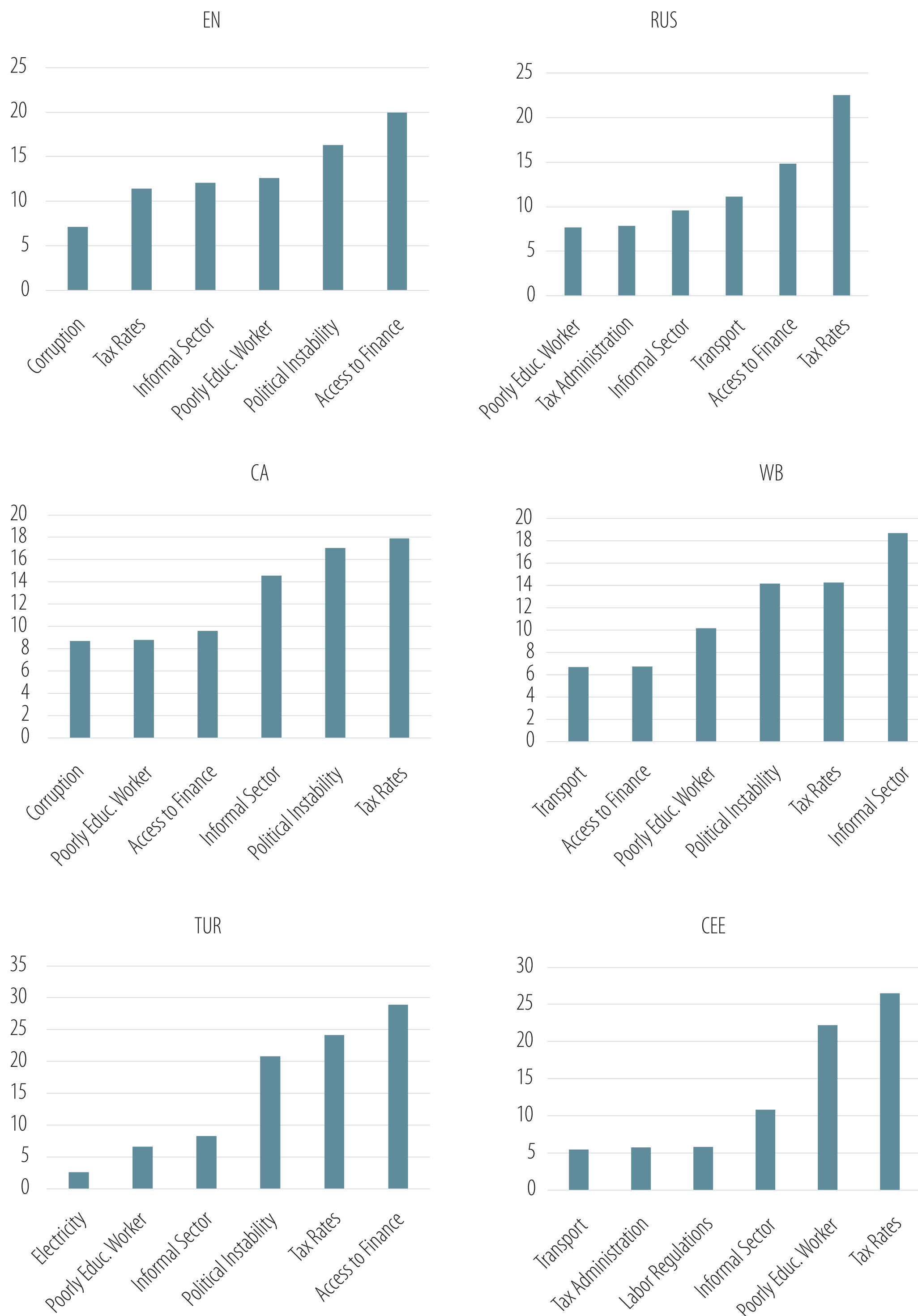
Firms continue to suffer mainly from unfair competition from the informal sector, a poorly educated workforce and limited access to finance. Firms in the Enterprise Survey (ES) were asked to select the “top obstacle” from a list of 15 potential obstacles. Figure 1 shows the top six obstacles affecting the day-to-day operations and performance of firms across the region. These are tax rates, competition from the informal sector (labelled informal sector in Figure 1), a poorly educated workforce and difficulties with access to finance. Access to finance scores among the top obstacles in all regions except for Central and Eastern Europe. Political instability also matters although in fewer regions, notably the Eastern Neighbourhood, the Western Balkans, Central Asia and Turkey. Transport is less of an obstacle but is mentioned in the Western Balkans, Central and Eastern Europe, and Russia.

2 Southern Europe (SE) comprises Cyprus, Greece, Italy, Malta and Portugal. The LMI and UMI aggregates are defined making use of the full sample of countries plus the countries covered by the EIB-EBRD-WBG Enterprise Survey 2019 in the Middle East and North Africa (MENA).

3 “Services” include retail and wholesale trade, hospitality, repairs, construction, information and communication technology (ICT) and transport. Not included in the survey are agriculture, fishing and extractive industries, as well as utilities and some services sectors, such as financial services, education and healthcare. Firms with 100% state ownership are also not included.

Figure 1

Top six obstacles to business operations – share of firms in the sub-regions of Eastern Europe and Central Asia



Source: Authors' calculations based on the EBRD-EIB-WBG Enterprise Survey.

I.II. Enterprises in Eastern Europe and Central Asia during the pandemic

Chapter 1 examines the performance and adaptation of enterprises in the region during the initial phase of the pandemic. It explores key determinants of firms' survival and ability to adapt, foreshadowing discussion in the rest of the report of the structural characteristics of the sector during "normal" times. Finally, the chapter examines the complementarity between financial sector "lifelines," the structure of corporate ownership, and policy support.

To date, firms have come through the pandemic better than initially feared. During the first wave, firms lost 25% of turnover and shed 11% of their labour force, with the pandemic hitting contact-intensive services and SMEs especially hard. But massive policy support helped to prevent large-scale bankruptcies, with only 4% of firms filing for insolvency or closing permanently at the time of the first wave of the COV-ES.

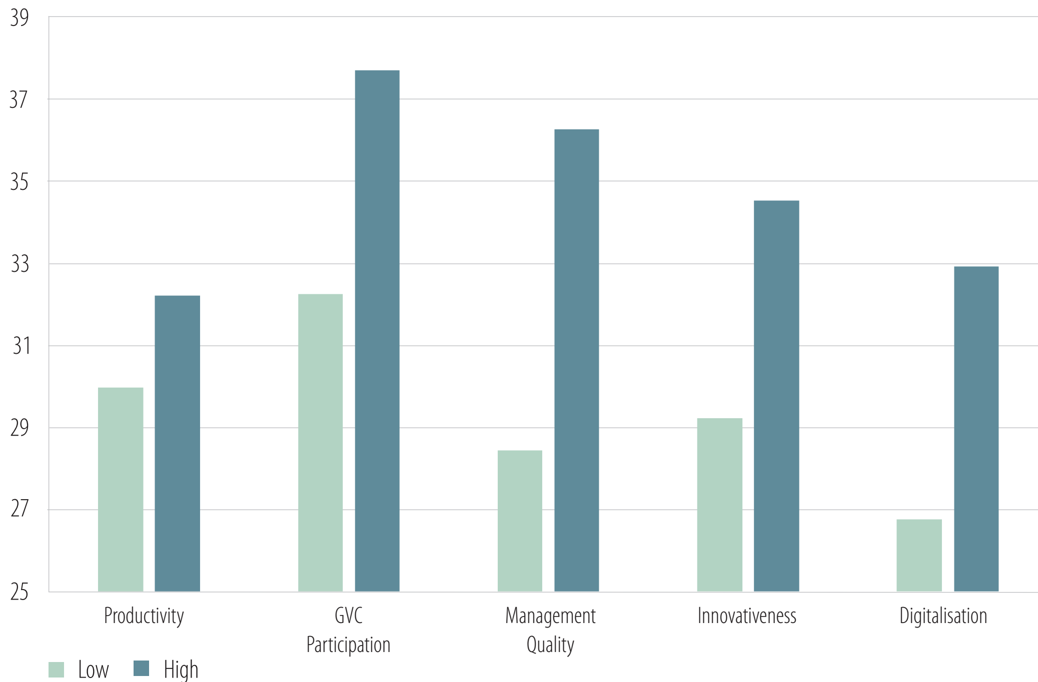
Some firms have been more resilient than others, rapidly adapting their business models to the pandemic (Figure 2). Firms that were more productive before COVID-19 were significantly less likely to close their businesses, to have arrears or to end up in bankruptcy. Instead, they expanded online business practices and switched to remote work. Firms that were integrated into GVCs, those that had been more innovative in the past, those that were more digitalised and those with better quality management also adapted better during the pandemic. They expanded their online presence, switched to remote work, adjusted production or took advantage of the available policy support more effectively.

Financial lifelines as an insurance mechanism played an important role in firms' survival. Firms with overdraft facilities and those operating in corporate groups with access to intragroup funding were less likely to experience bankruptcy, as they were able to draw down contingent liquidity under stress. Government programmes also played a stabilising role by mitigating the stress of vulnerable firms, such as SMEs, stand-alone firms and those lacking overdraft facilities.

Taken together, the findings in Chapter 1 suggest that many of the structural characteristics associated with stronger firm growth, job creation and innovation during normal times (as documented in Chapters 2-4 of this report) also helped enterprises during the pandemic.

Figure 2

Adaptation during the pandemic and firm characteristics (percent)



Source: Authors' calculations based on COV-ES.

Note: The chart plots the average predicted probability of firms' adaptation during the pandemic based on separate logit regressions on relevant firm characteristics pre-COVID-19. For productivity and management quality, "High" firms are those at the 90th percentile of the distribution. For GVC participation, innovativeness and digitalisation, "High" firms are those for which the relevant indicator takes the value of 1. See Chapter 1, section 1.4 for details on definitions and methodology.

I.III. Trade participation, innovation and competitiveness

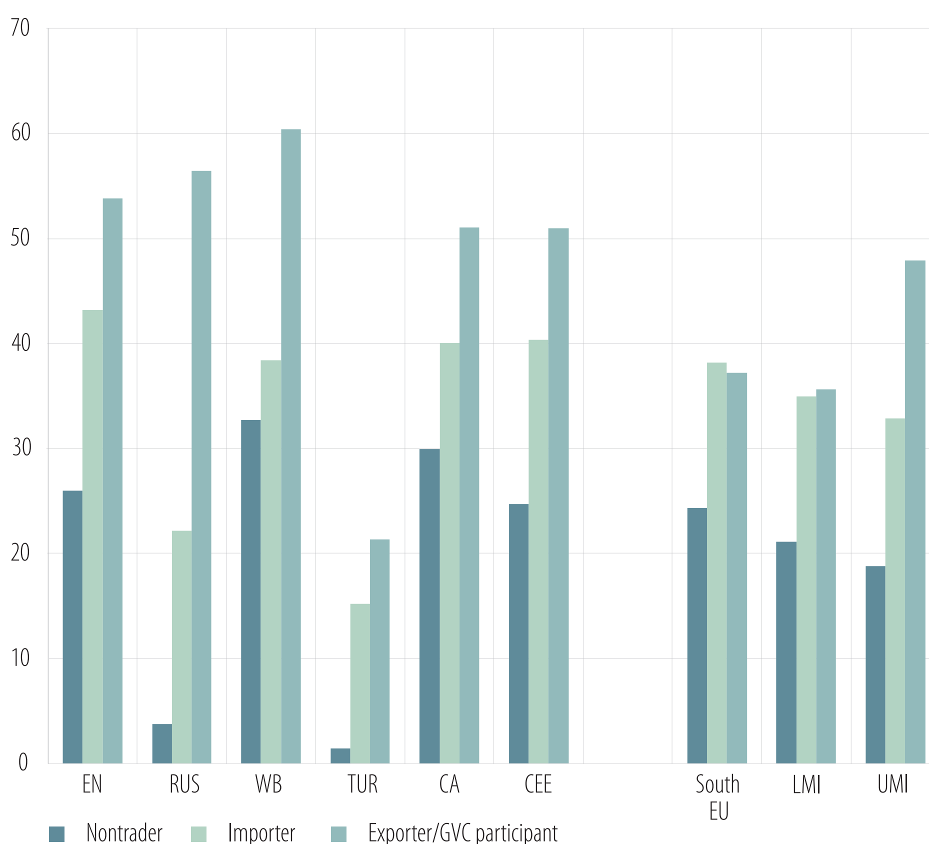
The findings of Chapter 2 indicate that globalisation has been essential in enabling many countries in the region to leverage their comparative advantages and increase their competitiveness. The chapter shows that firms participating in international trade, in particular in GVCs, tend to be more innovative, better managed and more productive.

Most firms in Eastern Europe and Central Asia engage in trade activity, and engaging in trade is positively associated with innovation. Overall, the breakdown of firms' trading profiles outlines the import dependence of most of the sub-regions. Moreover, most of the firms that export their goods or services also participate in GVCs by importing, transforming and adding value before re-exporting. But trade participation varies across regions. In Central and Eastern Europe and the Western Balkans, the share of firms that directly export goods abroad is significantly higher than the averages of lower- and upper-middle-income economies, while Central Asia and Russia lag significantly. An economic model oriented toward exports and industrialisation, supported by a proactive policy of attracting FDI, may enable transfer of technology and know-how, thereby supporting the rapid increase of productivity. The ES reveals that firms that trade in international markets tend to innovate more (see Figure 3). Among non-exporters, the share of innovative firms is about 30%, while it increases to around 40% for importers. Innovation is particularly prevalent among exporters and participants in GVCs (above 50% of firms).

Firms in the region generally invest more in innovation than firms in comparator economies, even though the innovation process is led by adapting new technologies developed elsewhere. Innovative firms tend to be more productive when they trade, while exporters tend to grow faster when they also invest in innovation. Innovation and trade are thus closely intertwined and both are necessary elements for improving firms' competiveness. Trade integration with developed economies, in particular the European Union, access to information and know-how through participation in GVCs, the use of foreign licensed technology and modern management practices all contribute to higher rates of innovation. Innovative firms and firms connected to international markets are more likely to adapt better and to be more resilient to COVID-19 shocks.

Figure 3

Innovative firms (percentage of firms)**, by trading profile**



Source: Authors' calculation based on the EBRD-EIB-WBG Enterprise Survey.

I.IV. The green economy

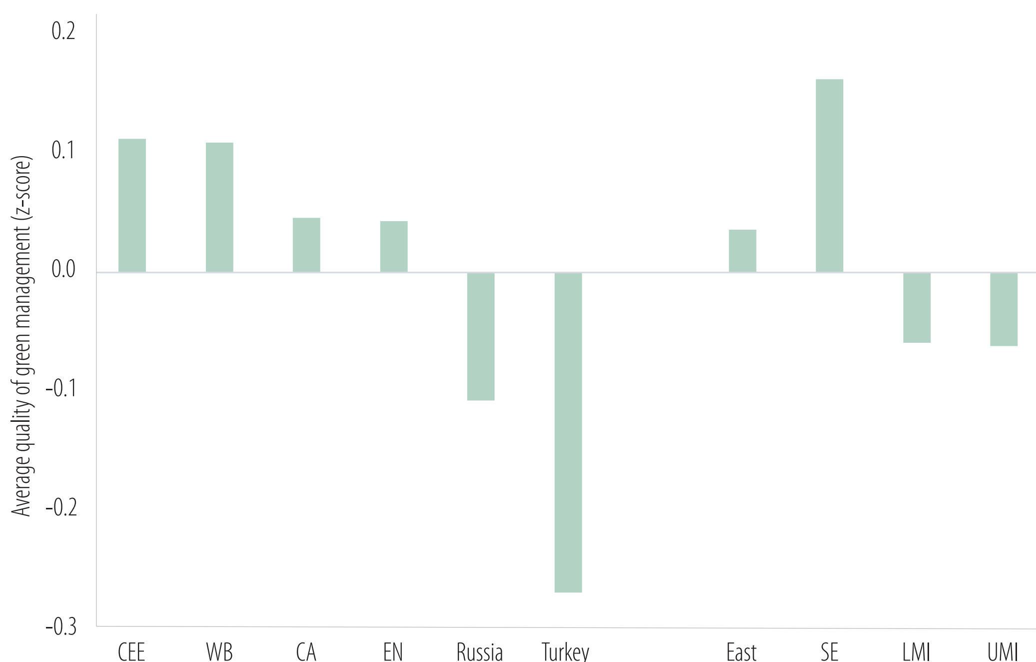
Firms can improve their environmental performance through the adoption of good green management practices (Chapter 3). These include having clear, measurable and realistic environmental objectives, together with managers' incentives and expertise to achieve those targets. Firms in Eastern Europe and Central Asia lag those in Southern Europe in the average quality of their green management practices (see Figure 4), particularly in terms of specific targets for energy use and emissions. External factors, such as customer pressure and energy taxes, play a more important role in determining the quality of green management practices than firm-level characteristics, such as size and age.

The ability to handle environmental issues in a proactive manner is just one aspect of effective management: the ability to handle social and governance issues is also important. Information on firms' environmental, social and governance (ESG) practices is often only available for listed companies. To fill this gap and shed some light on whether smaller firms in the region pay sufficient attention to ESG practices, Chapter 3 introduces a "Corporate ESG Responsibility" composite indicator. Firms in Eastern Europe and Central Asia lag those in Southern Europe on ESG practices too, with those with fewer than 20 employees, on average, the weakest in every sub-region.

In addition to improving their green management practices and their broader ESG practices, firms can also invest in energy efficiency and/or reducing pollution or other negative environmental effects. Firms are more likely to invest in a greater number of green measures if they experience fewer financial constraints and have better green management practices. Investments in energy efficiency are beneficial for the bottom line as well as for the environment. Policymakers should provide a business environment that is conducive to green investment and encourage all firms to improve their management practices and, more broadly, their corporate ESG responsibility.

Figure 4

The average quality of green management differs across sub-regions of Eastern Europe and Central Asia



Source: Authors' calculation based on the EBRD-EIB-WBG Enterprise Survey.

I.V. Financial deepening and firms' access to finance

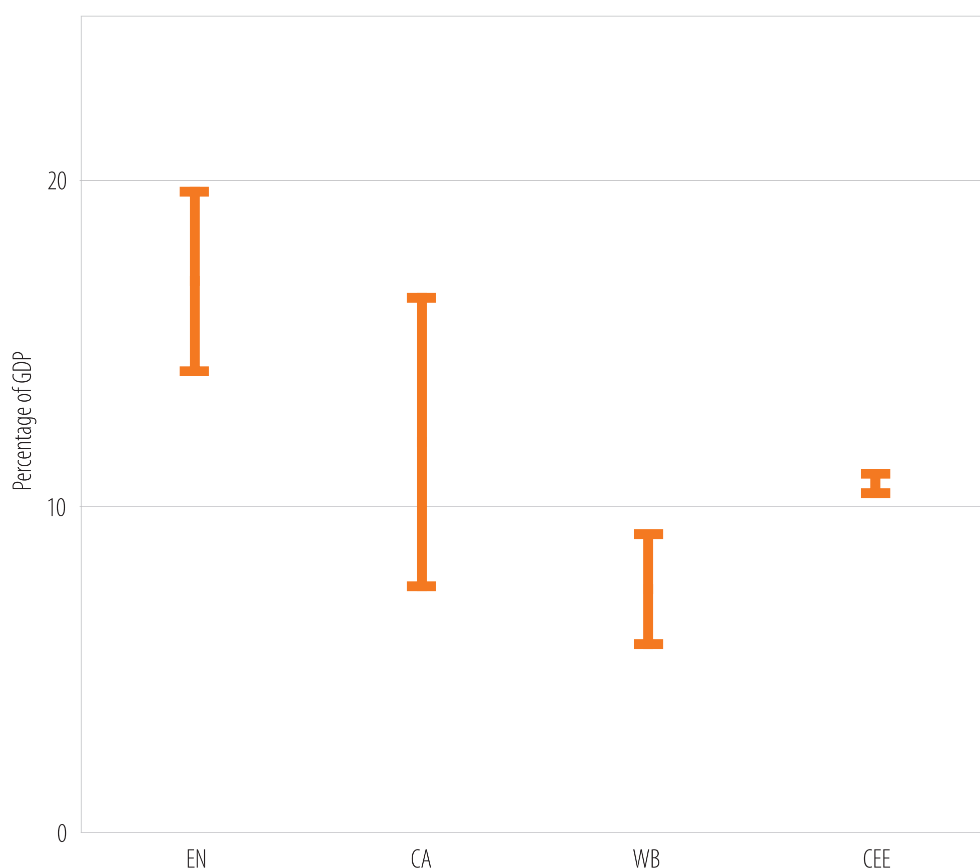
Chapter 4 documents substantial gaps in terms of financial deepening and firms' access to finance, particularly affecting SMEs and young and innovative firms in the region. About 55% of firms perceive access to finance as an obstacle. Credit constraints are particularly binding for SMEs and young firms: 24% of SMEs and 27% of young firms are credit-constrained. Innovative firms are also more likely to be credit-constrained, particularly young innovative SMEs. The chapter proposes a methodology for measuring credit gaps – the difference between desirable and actual levels of credit – making use of firm-level data. Figure 5 showcases the ranges of gaps as percentages of GDP for the major sub-regions investigated in the report.

The chapter also analyses the operations of financially autarkic firms, those that rely solely on internal financing. Financial autarky is more likely in less developed institutional frameworks: about 50% of firms in the Eastern Neighbourhood and Central Asia are autarkic, with a lower incidence in Central and Eastern Europe, Russia and the Western Balkans, and only 7% of firms in Turkey. Autarky is also a function of firm characteristics. More sophisticated, larger, older and more export-oriented firms are less likely to be financially autarkic. Autarkic firms are particularly present among SMEs and young firms.

Credit availability for firms is associated with higher investment and faster growth. While fully disentangling the impact of demand and supply factors on access to finance is challenging, the analysis establishes that credit availability for firms is associated with investment and growth, thus showing the practical benefits of being supported by and connected to the financial system. This implies the need for policies that promote financial sector development, such as improvements in collateral frameworks, and targeted financial and advisory support – for example, financial literacy and improvements in audit and accounting standards – in conjunction with a genuine reform agenda geared to improving institutional quality. These can help to reduce information asymmetries and increase firms' capacity, appetite and confidence in engaging with the banking sector.

Figure 5

Estimated credit gaps as percentages of GDP for the major sub-regions in Eastern Europe and Central Asia



Source: Authors' calculations based on the EBRD-EIB-WBG Enterprise Survey.
Note: These figures represent the total credit gap in a given region (as a percentage of GDP). They are computed making use of the methodology explained in Chapter 4: see Section 4.4 and Annex D for a methodological description of the key stages for determining a credit gap. The bands are determined applying different parametrisations, thus reflecting alternative risk aversion parameters.

I.VI. Conclusions and policy implications

The COVID-19 outbreak put businesses in Eastern Europe and Central Asia through a severe test. Their resilience has been enhanced by effective policy support, as well as by their achievements before the pandemic. To date, the corporate sector has been resilient to the COVID-19 crisis, supported by the unprecedented policy response that eased the financial strains facing firms through a wide array of measures. Banks and other financial intermediaries also played a critical role by maintaining the flow of credit to the economy. As the analysis in this report demonstrates, firms with access to bank lifelines prior to the pandemic or with support from a corporate group could absorb the cash flow shock more easily and were significantly less likely to experience bankruptcy. Government policies played a stabilising role, especially for firms that lacked access to formal and informal lifelines before the pandemic (Chapter 1). The COVID-19 outbreak also demonstrated clearly that firm characteristics associated with stronger growth and productivity prior to the pandemic, namely their integration into global markets, as well as their innovativeness, managerial quality and digitalisation, helped businesses to adapt to the new economic circumstances. These findings underscore the important role that government policies can play in further strengthening business resilience in the region.

Engaging in trade and integration via global value chains is important for firms in the region, as trade is positively linked to productivity, innovation and growth. The findings in Chapter 2 indicate the importance of policy measures aimed at further strengthening trade integration and innovation. Improving customs and trade regulations, which lowers entry costs for firms seeking to engage in trade, will increase access to international markets for a larger share of firms, especially smaller ones. Policymakers should prioritise investment in digital infrastructure and facilitate improvements in management practices and investment in workers' skills. Governments could encourage intensive training programmes, in particular aimed at improving the management of SMEs and enhancing incentives to reskill the workforce, including in less well-connected areas so as to attract innovative firms. Combined with investment in digital infrastructure, this could help to rebalance discrepancies within the region in terms of development and to improve resilience and adaptability to shocks, such as the COVID-19 crisis.

Policymakers should prioritise investment in green infrastructure, and strive to provide a business environment that encourages all firms to improve their management practices and, more broadly, their corporate ESG responsibility (Chapter 3). The transition to sustainable growth and a green economy will only be a success if the private sector applies its ingenuity, investment and entrepreneurship to that endeavour. Firms can improve their environmental performance through the adoption of good green management practices and by making green investments. Green management practices are important for all types of green investments, and external factors, such as customer pressure or energy taxes, are more important determinants of the quality of green management practices than firm characteristics. This suggests that there is a role for government guidance and stricter regulation.

Continued development of the financial sector will be essential not only to improve firms' access to formal lifelines when faced with liquidity shocks, but also to relieve credit constraints that limit firms' growth during normal times (Chapter 4). The report documents the persistence of gaps mostly linked to a mismatch between demand and supply: realigning the two requires increased institutional focus on credit market infrastructure. Improvements in collateral frameworks can help to tackle inefficiencies in the allocation of credit, to reduce risks and to increase the accessibility of credit. Targeted financial and advisory support can reduce constraints and increase firms' investment opportunities, particularly for SMEs, young and innovative firms. Further diversification in terms of financial instruments and products is warranted. For example, the deployment of guarantee schemes can boost the risk-taking appetite of banking sectors, while their effectiveness can be enhanced via better risk assessment and screening capabilities. Moreover, financial literacy as well as improvements in audit and accounting standards, in conjunction with a genuine reform agenda geared to improving institutional quality, can reduce information asymmetries and increase firms' capacity, appetite and confidence in engaging with the banking sector.