

The Balkans: New investment opportunities with manageable risks

by Philippe Valahu, MIGA, World Bank Group

EU accession could flatten the competitive advantage of doing business in some Eastern European nations. Now, savvy investors would do well to look to the Southeast – a recovering Balkans region, stabilised and offering tremendous opportunity to get in on the ground floor. With opportunity comes risk, however. Understanding the nature of the risk, and taking the proper steps to mitigate potential problems, can reduce investment costs and increase the potential for success.

Before there were “business silos” there was “Balkanisation.” They meant the same thing: fragmented, hostile business units firm in their refusal to communicate or cooperate across boundary lines.

The Balkans, the Southeastern European region best known for spawning the first idiom, representing its history of ethnic fractiousness, is poised to turn the idiom on its head. Newly independent nations are working overtime toward negotiated resolution of long-held disagreements while racing to create the legal and regulatory infrastructures and the positive business environment that foster economic growth and attract new foreign investment.

For investors – particularly those in labour-intensive manufacturing sectors or back-office service sectors – this could be the perfect time to make a move. Consider this shortlist of competitive advantages: a huge, emerging market of 150 million people sitting on the doorstep of the EU; a driving desire to do what it takes to complete the transformation to market economies; access to seaports, rail and highway; a low-cost, underemployed labour force with strong engineering skill sets and an eagerness to get back to work.

Quantifying opportunity

A look at trends in one industry – automotive manufacturing – offers insight into the scope of potential. Whereas Western Europe employs some 12 million people today, analysts suggest that the industry’s eastward march is already altering this calculus. The number of new cars produced in the Czech Republic increased 35% in 2005, while France, Spain, and Italy all posted losses. Germany and UK production levels stayed flat. In the past two years alone, the automotive industry in Eastern Europe has spawned more than 100,000 new jobs, while Germany and the UK – once bastions of global automotive manufacturing – together created less than 10,000.

The reason, of course, is extensive cost savings.

The same factory job that pays €25.8 per hour in Germany pays €4.2 per hour in the Czech Republic, according to Germany’s Centre for Automotive Research.

“There are severe downward pressures on costs for automotive manufacturers today, and this is clearly impacting their site selection decisions,” says Dermot Coffey, of the Austrian-based European Investor Outreach Program (EIOP), administered by the Multilateral Investment Guarantee Agency.

While accession into the EU has meant good things for the nations most closely associated with the emerging automotive manufacturing clusters, it also comes with a downside – call it the price of economic success. Simply put: it is becoming more expensive to do business in the EU-8 than it used to be.

“Costs are going up in the Czech Republic, Hungary, Poland, following their accession into the EU, and the growing popularity for manufacturing,” notes Roel Speel, a consultant with IBM Global Location Services. “Already we are seeing some automotive components and electronics assembly moving out of these countries to places like Romania and Bulgaria because of the cost differential.”

The statistics bear this out: “The proportion of FDI in South East Europe to total FDI in the emerging democracies in Central and Eastern Europe rose from around 13% in 2000 to more than 23% in 2004,” notes a recent report from Raiffeisen Research.

Balkans poised to become newest investment haven?

Particularly for labour-cost sensitive industries such as automotive and electronics, any slight uptick in cost causes major pain. “These companies are under so much cost pressure that even another 20% increase could cause them to look elsewhere, and they are starting to do so,” Spee says.

A recent benchmarking study of the automotive industry conducted by EIOP reveals that automotive

firms could reduce plant operating costs by 60% with a move from the Czech Republic to one of the Balkan nations: Serbia and Montenegro, Bosnia and Herzegovina, Macedonia, Croatia.

"As countries progress up the development scale," Coffey says, "they might not be as competitive any longer in certain areas, so companies might look for other location solutions. These solutions can be found in the Balkans," he adds.

Already, some automotive companies are dipping their toes into Balkan waters, and discovering that the water feels just fine. Take Japan's Daido Steel, a major supplier to Nissan, Honda, Toyota and Mitsubishi, all of which are engaged in aggressive European market penetration plans. The company is building a ball bearing factory in Montenegro to support its customers' growing European production base.

US automotive component suppliers, reeling from the troubles of American carmakers, are also looking for salvation in the Balkans as they restructure their own global positions, closing facilities in higher-cost locations and moving to less expensive spots. For example, Michigan-based Dura Automotive Systems is consolidating multiple facilities, closing some, even as it constructs a new control systems plant in Bosnia and Herzegovina.

EU accession goals strengthen appeal

With the goal of EU accession in mind, Balkan governments are pushing the reform agenda forward, some with more success than others.

"The one thing that unites all of these countries is their desire to become EU members. They are all on the road to becoming market economies," says Coffey, whose programme assists potential investors as they consider projects in the Balkans. He says that investors would do well to get in early, as the Balkans increasingly are strong country contenders for foreign direct investment (FDI).

"We know from the example of Ireland in the early 1990s, and of Central Europe that companies with the early mover advantage got scaled up earlier, and were able to take the most advantage of the untapped opportunity," Coffey says.

The next wave of EU accession countries includes Bulgaria and Romania, followed by Croatia. Especially for manufacturers, this changing European landscape presents opportunities to realise cost efficiencies in relocating or expanding their export platforms. And as GDP continues to show strong growth, consumer markets will expand as well, creating massive new markets for locally manufactured products.

Beyond the Balkan stereotype

Labour-intensive, land-intensive industries – like automotive manufacturing – could uncover ideal

locations – in countries eager to put the past behind them. That past includes not only a protracted history of ethnic violence and civil war, but of byzantine business processes that could make something as simple as filing for a business licence a complicated, prolonged multi-step ordeal.

But with governments in the region committed to attracting FDI, progress is occurring on several fronts, including regulatory, fiscal and tax reforms, and investor incentives. A recent World Bank report – *Doing Business 2006* – details an impressive list of business climate reforms taking place across the Balkan countries: In Serbia, a company can start operating in 15 days, compared to the 51 days it used to take. Macedonia and Serbia adopted new labour laws, making regulation more flexible. Three new private credit bureaus kicked off operations in Lithuania, Romania, and Slovakia, making it easier for lenders to assess creditworthiness. The Bulgarian public credit registry launched an online system, cutting the time to retrieve data from three days to seconds. The registry also scrapped the minimum loan cutoff, expanding the coverage of borrowers nine-fold.

Several Balkan countries also made it easier to create and enforce collateral agreements: Bosnia and Herzegovina, Croatia, and Romania. Serbia reduced the time to enforce a simple contract in the courts, from 1,028 days to 635. Romania introduced a 16% flat tax and cut payroll taxes. Albania and Bulgaria slashed corporate taxes, making them even more interesting potential locations for FDI.

The region boasts a low-cost, high-quality workforce – eager to work in an area beset with high unemployment. In fact, the EIOP benchmarking report notes that current investors cite local technical expertise and the region's strong work ethic as competitive advantages.

Yet foreign investors might not be looking beneath the stereotype. "A lot of foreign investors have this perception of very backward countries, with workers that have low skill levels, and in many cases, that perception is not true," says Spee. He notes that Belgrade, for instance, offers enormous potential for back office operations with a large student population bringing multiple language capabilities. "Belgrade is a lot like Prague, but companies just don't feel the same level of confidence going to Belgrade as they do going to Prague," he notes.

Balkan recovery a work in progress – MIGA guarantees offer peace of mind

To be sure, risks remain, and several politically volatile issues, such as the status of Kosovo, remain unresolved. "Investors who are unfamiliar with the area are

understandably put off by what they read in the international press. Many are still nervous about investing in areas that suffer an image overhang from the dark days of the 1990s, even though the reality is different," Coffey notes.

With several nations facing important elections in the coming months, the situation may seem anything but stable for some investors who might be curious about the opportunity, but wary of the risks.

This is precisely where the backing of a multilateral institution like the World Bank Group, and instruments such as political risk insurance can help, say experts. MIGA – the Multilateral Investment Guarantee Agency – is uniquely suited to the role of public political risk insurance provider. The agency offers coverage against the risks of transfer restriction and inconvertibility, expropriation and war or civil disturbance – including sabotage and terrorism. MIGA is an arm of the World Bank Group, with members that include virtually every nation in the world. As signatories to MIGA's convention, nations often are less inclined to act in ways that could adversely affect investments.

"Companies feel that the political stability isn't guaranteed. Many are still quite hesitant. Just having the name of the World Bank behind them could be part of the reassurance they need to take a closer look," Spee says.

Certain projects, such as infrastructure investments that require massive amounts of upfront capital and cooperation with public authorities, come with an added level of risk that also can be mitigated with political risk insurance (PRI). "Investors in large infrastructure projects, like roads or rail, may want the comfort factor of PRI before they make an investment," says Coffey. "Working with governments, there is a huge concern about breach of contract. And PRI can help."

PRI can lower project costs

Even for investors who feel confident about the opportunities in the region, and who are undaunted by the region's remaining uncertainties, there is another unpleasant reality they may face: it could cost more to access project finance for investments in emerging market nations.

While the reality is that the political risk factor is leveling off in the Balkans, the perception of risk remains. Financial institutions, based on ratings ascribed by agencies such as Moody's, assign a country risk premium to capital destined for nations perceived to have increased potential for problems such as transfer restriction, expropriation, civil disturbance, and breach of contract. The premium attached can send project costs so high that the deal becomes economically unfeasible. But financial institutions take into account

mitigating factors, such as PRI, when they determine cost of capital.

"The big advantage of PRI is that a company can go to a bank and say, 'we have political risk insurance' and that will reduce the cost of financing," Coffey says.

In some instances, the use of guarantees can improve a project's country rating, even raising it a few notches when it benefits from a robust financing structure and significant risk protection such as that offered by MIGA.

Bond issues, increasingly used in developing countries as a source of capital funding, are also constrained by the perception of risk. Political risk coverage can also offset risk perceptions that have a detrimental effect on the rating of a bond issue, thereby making the issue more palatable to a broader pool of investors and lowering the cost of the issues.

MIGA-backed financial sector projects set stage for new investments

Manufacturing is not the only sector experiencing resurgence in the Balkans. Indeed, it is often the financial sector that acts as a so-called first-mover: the first to go into a frontier market following a crisis such as war.

MIGA has been particularly active in the development of the financial sector in the post-war Balkan countries. In fiscal year 2005, MIGA supported 22 projects through its guarantees programme and undertook 25 technical assistance activities in the region.

For example, in Albania – which has lagged behind other Balkan nations like Croatia in terms of development – a nascent banking industry received a major boost a few years ago when the Commercial Bank of Greece invested in the Intercommercial Bank S.A. Albania. MIGA guarantees protect the bank's equity investment against transfer restriction, expropriation, and war and civil disturbance. The investment introduces a number of financial services previously unavailable in Albania – making it easier for companies to access local financing sources, especially in project and trade finance.

MIGA also has been instrumental in supporting the investments of Austrian bank Raiffeisen Zentralbank Österreich in Eastern Europe. When RZB first forayed into the region towards the end of 2000, political risks abounded. Many of the region's financial systems were emerging from restructurings, privatisations, and in some instances civil war. It would have been inconceivable to establish a banking network under such conditions without the appropriate mitigation and sharing of risks. MIGA has guaranteed RZB's investments, not only in banks but in leasing

companies as well, in Belarus, Bosnia and Herzegovina, Croatia, Czech Republic, Romania, Russian Federation, Serbia and Montenegro, and Ukraine.

The stabilising of the banking sector – and the broader effort to develop capital markets in the Balkans – is a positive sign for investors in other industries, say finance experts. "The broadening of financial markets in Romania and Bulgaria has helped attract more foreign direct investment," says Mag. Peter Brezinschek, head of RZB's division of economics and financial markets research. "This activity is still in the early stages in nations like Bosnia and Albania, where there aren't sufficient market instruments and where stock exchanges are very poor in terms of capitalisation." He says that the capital markets sectors will mature as governments continue with their reform agendas.

Path forward: Drive to EU acceptance brings opportunity

Clearly, the time is now to consider a Balkans investment. With nations setting paths to EU accession and transition to market economies, it is the early movers who will reap full advantage of the enormous untapped potential.

Already, things are changing. Ratings agency Moody's recent upgraded Bosnia and Herzegovina's

foreign currency credit rating from "B3" to "B2", with a stable outlook. The agency cited the enforcement of economic reforms and significant industrial production growth of 7.5% in 2005 as factors in the upgrade.

Investors are moving in, particularly in manufacturing, in financial services, and in agriculture. Getting in early gives investors a leg up on the competition for skilled workers, and offers first choice for strategic positioning within what is sure to become a vast free-trade area. As demonstrated in the economic booms of recently acceded EU member countries, the period leading up to full EU integration is a strategic time for forward-looking investors. Partnering with a political risk insurer like MIGA can help investors maximise that opportunity.

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