

Regional analysis Competitiveness

Competitiveness craving for unpopular decisions

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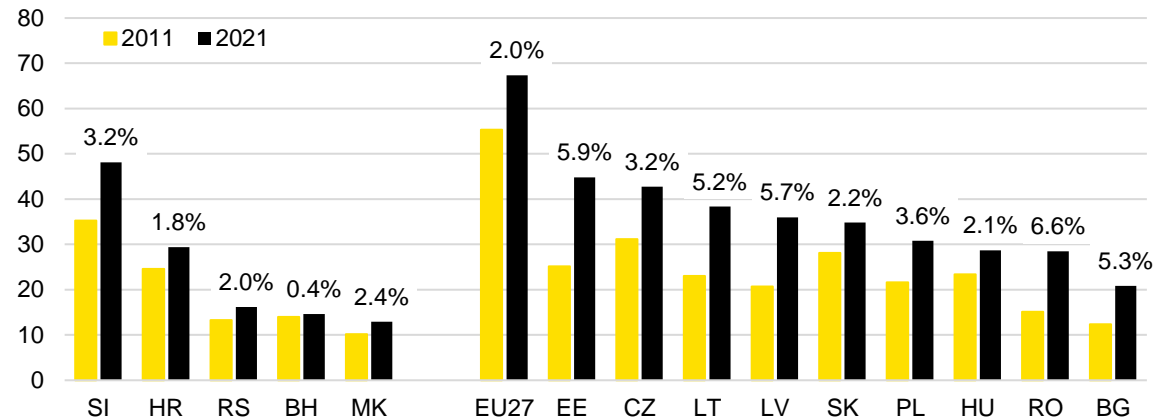
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With 20+ years of transition and convergence behind, we are taking a detailed look into the competitiveness developments of Adria countries vs. CESEE peers. Aside from highlighting competitiveness rankings made by third party centres in areas such as business environment, we are also going through high level macro results reflecting competitiveness basics.

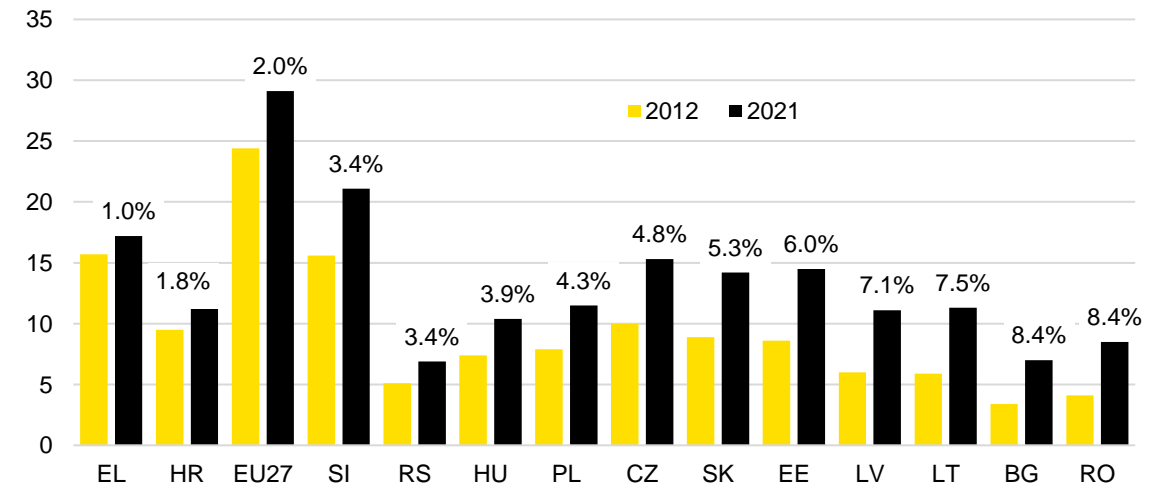
We are looking into the **gross value added (GVA) per employee** as to determine an economy-wide success of corporates' gross profits. Although this indicator is a result of competitiveness itself, we also see it as an element driving investments – investors are attracted by success stories. All **Adria countries** saw an **increase in GVA per employee over the last decade**, with Slovenia placed at the top level in CESEE. However, **increase in labour productivity was much stronger in other CESEE peers than in Adria countries**, with only Slovenia fitting somewhere in the middle of CESEE labour productivity upgrades. We interpret the named trends as that most of Adria countries went through the so-called internal adjustment during big part of 2010s. Most other CESEE peers have entered 2010s at a lower economic base and concentrated more on economic upgrades by luring investments. Indeed, within GDP structure, CESEE peers saw investments at 22% of GDP in the last ten years, while Adria countries saw capex at 20% of GDP – marginally lower, but still sending a message.

Labour cost dynamics in the private sector show a mixed picture. We see **labour cost increases in CESEE peers over the last decade much higher than in Adria region**. This means that the mentioned increase in labour productivity stood behind the upgrade of the private sector, which then fuelled the demand for higher salaries. In all, **companies in Adria region defended their profitability by taming increases in workers' salaries**, while (most of) profitability gains from higher productivity at other CESEE peers were eaten up by compensation hikes. The labour productivity from above shows the whole economy, while the labour costs we display for the private sector where salary increases were higher than in the public sector, again reflecting the development of the private sector. Another key fact – some specific elements are driving salary movements, where for example a sizeable share in private income comes from renting in the tourism sector. We see this item curbing salary movements in Croatia, similarly as in Greece, an economy with similarly high dependency on (foreign) tourist income.

Labour productivity - GVA per employee
(ths EUR per employee, % values present CAGR)



Labour cost for LCI (compensation of employees plus taxes minus subsidies) in private sector as EUR per hour; sorted ascending to CAGR changes

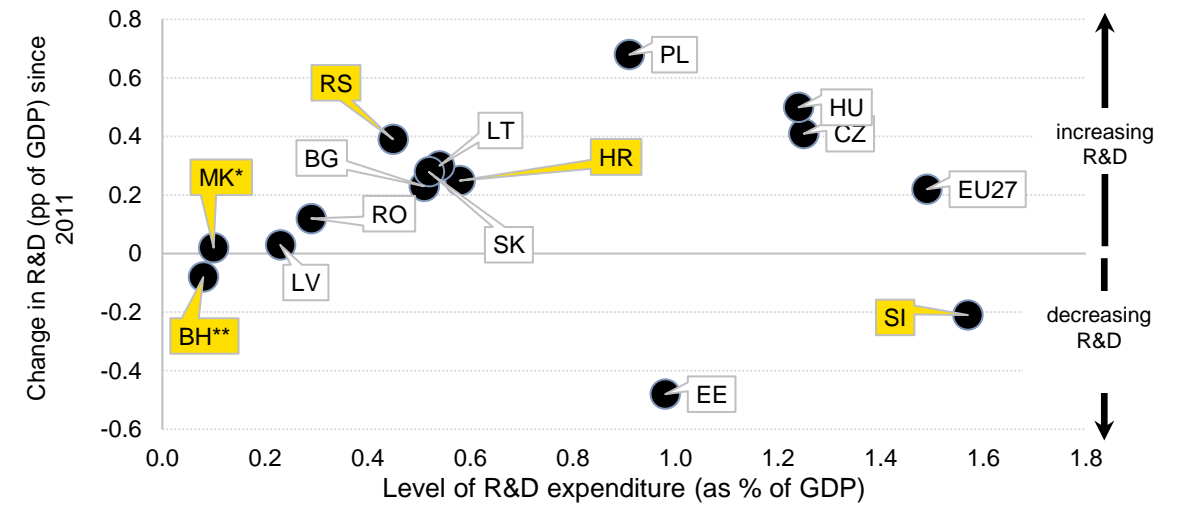


Source: Eurostat and national statistic offices, Bloomberg Adria analytics

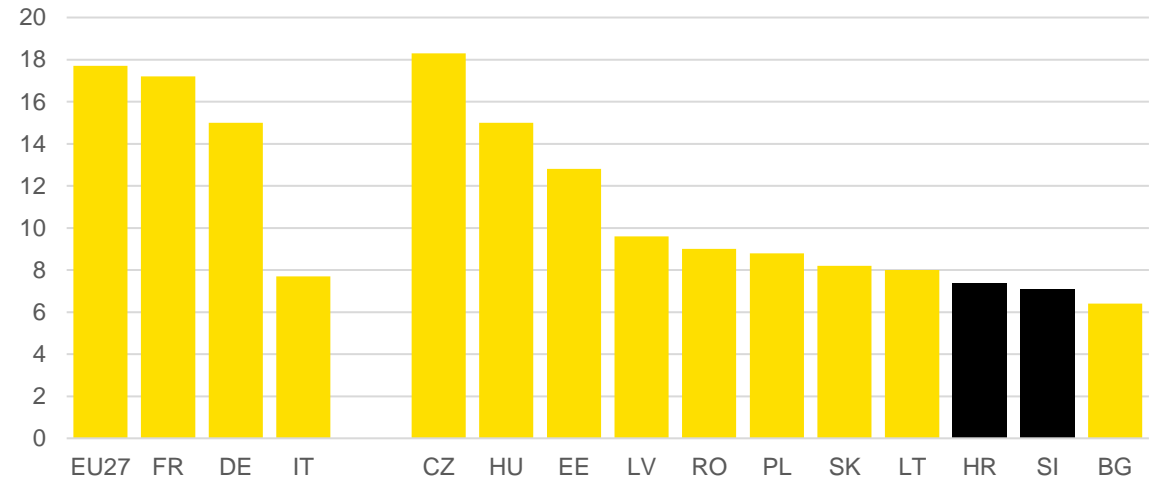
Next we are observing **spending on R&D as a share of GDP**. Again a **mixed picture** is on hand, with **only Slovenia of all Adria countries generating higher R&D expenditure vs. EU27 and outperforming all CESEE peers**. We see such development in Slovenia being a result of the economy in highest level of transition among CESEE countries and convergence towards the Euro area's strongest economies. Needless to mention that Slovenian economy benefits from a mix of small economic size and relative close distance to the Europe's most developed production centres (i.e. Germany, Austria etc.). Still, Slovenia is among few countries in CESEE to witness reduction in R&D spending over the last decade, reflecting, for example, that some R&D activities were dislocated abroad. **Bosnia and Herzegovina and North Macedonia** carry by far the **lowest R&D spending figures in CESEE**, reflecting a relatively narrow base of high value-adding production and a failures to lure in foreign investments into R&D facilities. **Croatia and Serbia** are somewhere in the middle of CESEE distribution of R&D spending, meaning that both the current R&D spending levels and dynamics over the last ten years are on CESEE average at best.

Among the **reasons for distribution of R&D spending** we see importance of the mix of the (timing of) **EU membership** and **geographical proximity** with the Europe's strongest production centres. CESEE outperformers in terms of R&D are Slovenia, Czechia, Hungary and Poland – all countries which traditionally have close foreign trade ties with the EU industrial front-runners (Germany, Austria). These CESEE countries bear the fruit of almost 20 years of the EU membership i.e. customs-free exporting to couple of World's most developed economies, and except for Slovenia all carry the advantage of economy of scale. Aside from **era of cheap money during 2010s** which supported investments, another key element fuelling the R&D expenditure is a **high share of economy employed in the manufacturing sector**, especially vs. Adria region except Slovenia. Still, the fact that the EU27 spending on R&D outperforms almost all CESEE countries is tied to the EU's biggest economies keeping a big doze of R&D facilities at their headquarters and dislocating (parts of) production into areas with cheaper labour i.e. CESEE. This is then the best reflected by the fact that CESEE is mostly exporting towards the EU's biggest economies and this in the form of intermediate goods, while the EU biggest economies are exporting more capital goods and carry bigger share of exports to the rest of the World.

R&D as % of GDP – business sector – 2021 level vs. 10Y change



High tech exports - % of total exports

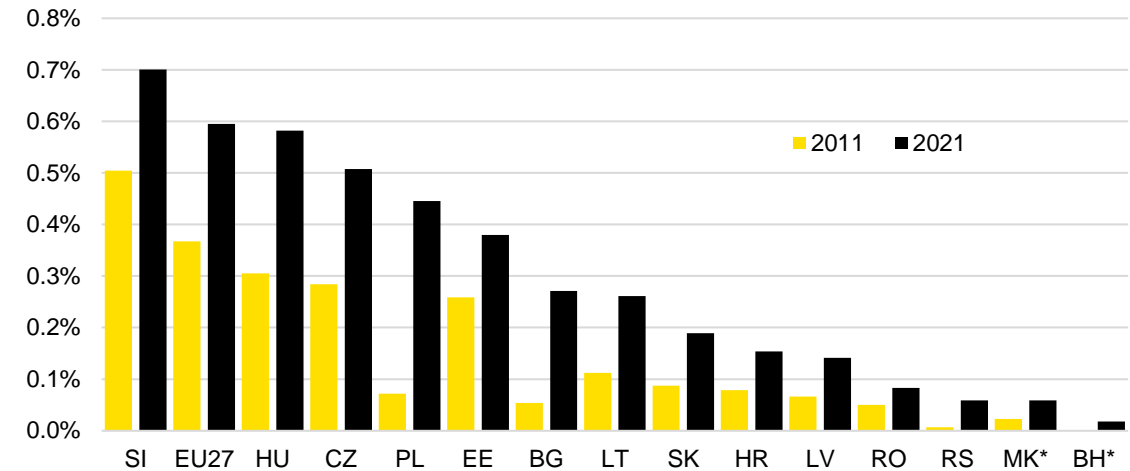


*first value 2015; **first value 2012
Source: Eurostat, Bloomberg Adria analytics

Share of researchers within the full number of employed correlates strongly with the R&D spending figures, with **Slovenia outperforming both the CESEE universe and the EU27 average**. The rest of the Adria region is on a weaker end of spectrum, carrying small number of people working in R&D. In terms of competitiveness views, even more important are the upgrades in the number of people working as researchers in countries such as Poland, Hungary, Czechia, Bulgaria etc. Such developments are another evidence of competitiveness gains as the related activities result in higher value adding outputs and feed into multiple gains elsewhere in the economy. An important element is that researchers in CESEE are still strongly concentrated in the public sector (legacy of communism times which runs quite slow transition towards the private sector), hence we see an upside potential for R&D spending in the private sector towards CESEE and as a result potential for higher share of researchers to be employed therein.

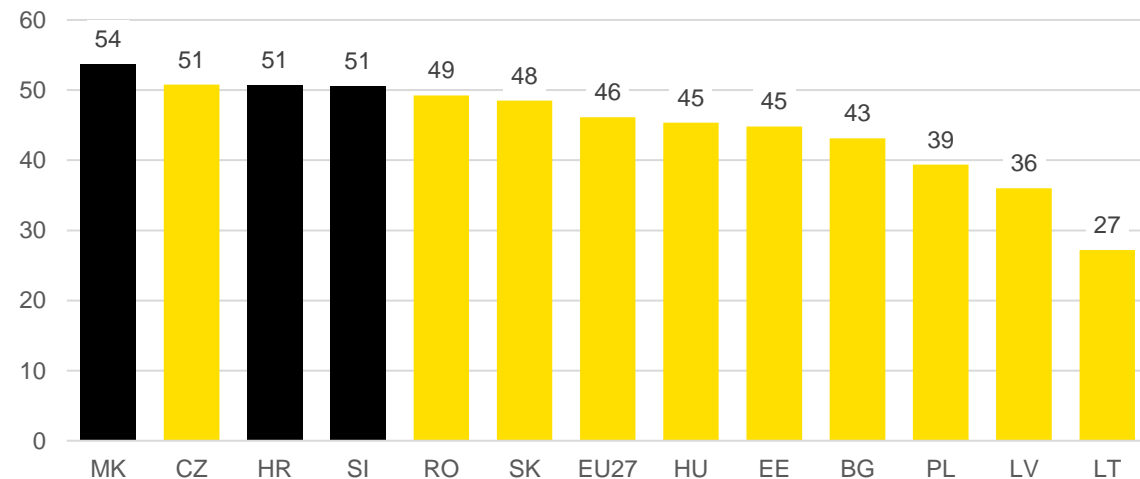
Adria region countries are **surprising positively** when it comes to **survival rates of newly formed enterprises**. Namely, according to the Eurostat data, survival rates for enterprises in five years after the setup are at the top of CESEE space for countries like North Macedonia, Croatia and Slovenia. Since this does not correlate strongly with other business environment indicators produced by third parties, we suspect that there are also some methodological challenges in the background e.g. the existence of the so-called „zombie firms” in Adria region, which have one employee registered and no turnover reported at all. Another element supporting lengthier survival rates in Adria region is quite tight economic base i.e. relatively lower level of competition on the local market which allows for business laggards to thrive longer as would had been in the face of higher competition.

Researchers (business sector) as % of total number of employed



*latest data 2020

Enterprise 5Y survival rates - % of enterprises started in 2015 and survived until end 2020**



**includes enterprises without turnover; Source: Eurostat, Bloomberg Adria analytics

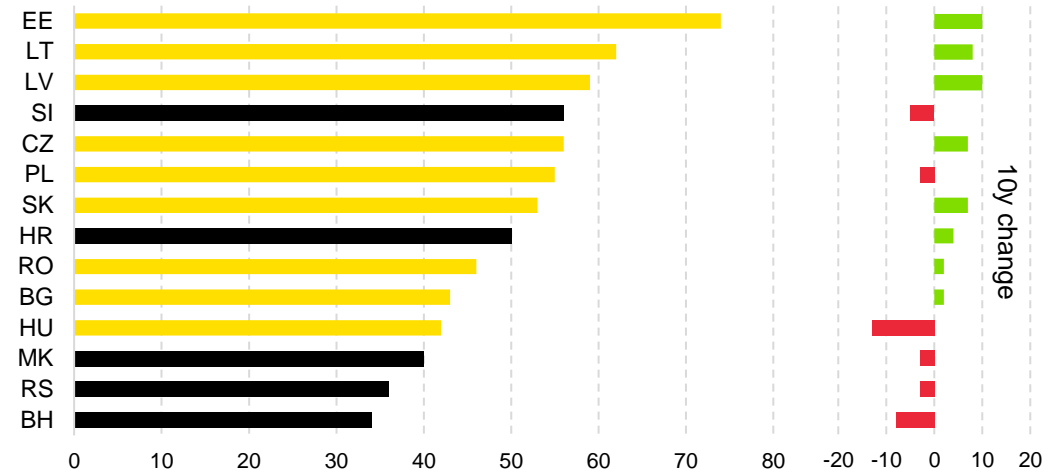
In this part of the competitiveness analysis, we make a brief overview of widely used indices produced by third parties. In general, the Adria region shows poor performance when it comes to both, corruption and innovation indicators, in comparison to other CESEE countries. The key reason is that Serbia, North Macedonia and Bosnia and Herzegovina rank at the bottom of the CESEE region.

Fight against corruption within the non-EU part of the region is apparently more formal than factual. The main impediment is certainly tied to unstable and/or autocratic political structures and relatively weak rule of law. Especially in Bosnia and Herzegovina and North Macedonia where multinational structures are pronounced and often do not have the same agenda. As the corruption perception index is decreasing in non-EU countries, we cannot see any improvement until some actions are undertaken. For **North Macedonia and Bosnia and Herzegovina we see the much-needed EU funds as a critical element to potentially fuel improvements** in the perception of corruption since the effective money utilization out of these EU funds will inevitably require enhancements in the public administration functioning, notably in terms of transparency and clear money flows. Still, the reason for highlighting those non-EU countries is purely due to their low base so any improvement in the mentioned functioning creates a material outcome. Slovenia is the best rated country in the region, though still behind the Baltic states. Croatia follows by posting index value close to the CESEE region average.

When it comes to Innovation index, the picture of the region is similar to that of corruption rankings. Slovenia and Croatia are better ranked, in line with CESEE region averages, while Serbia, North Macedonia and Bosnia and Herzegovina post lower rankings. **The most important element we see in the last ten year changes, with all Adria countries except Bosnia and Herzegovina and Croatia marking a deterioration in the innovation index over the last ten years**, going close to messages by other competitiveness elements reported earlier. The most worrisome is a negative development at Slovenia, especially given the economy's high R&D spending and orientation to mid-to-high tech production complexity.

Corruption Perceptions Index 2022

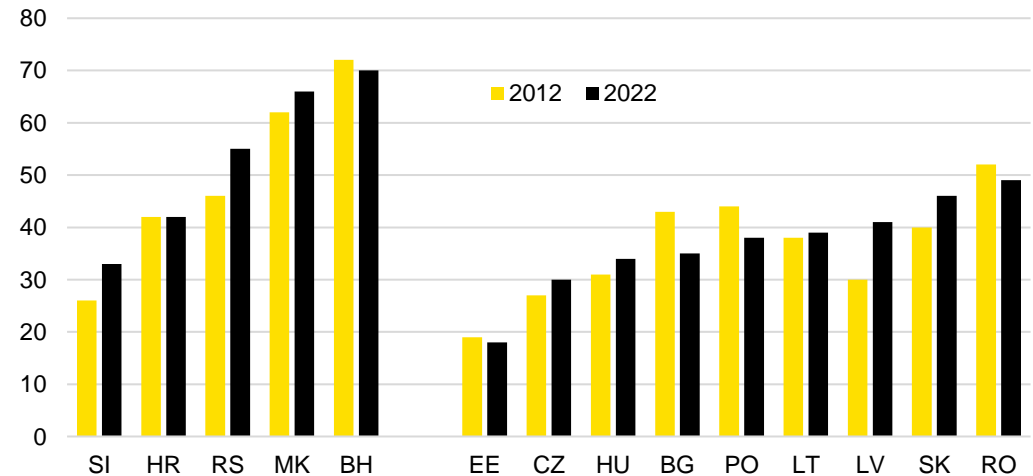
(100 - very clean to 0 - highly corrupt)



Source: Transparency International

Global Innovation Index rankings

(smaller rank indicates better innovation index)



Source: WIPO

In the **next few years we do not expect any material upgrades in Adria region competitiveness against CESEE peers**. We see the following reasons as mostly critical:

- economic environment has deteriorated with a detrimental mix of prolonged period of high inflation alongside increased geopolitical risks
- the above elements are feeding into the government complacency in multiple areas – the best example is that the restructuring economic environment (e.g. high inflation) is pushing the governments towards short-viewed fiscal aids and highly ignoring badly needed mid-to-long term competitiveness improving reforms; simplified, none of Adria region economies are aiming to utilize the reshaping of economic environment for self-proclaimed economic reforms, but rather opt for short-term social solutions and/or foreign-imposed adjustments (e.g. EU's green transition);
- **Slovenia** and **Croatia** are the best examples given they already achieved their key national goals (e.g. participations in EU, EA, Schengen, NATO etc.), which alleviates the motivation for reforms; Croatia carries some potential in its ambition to join the OECD, however we do not see that as a spectacular element to fuel massive competitiveness outperformance vs. the rest of CESEE in the next few years.

The biggest **potential** in Adria region we see for **North Macedonia**, albeit largely thanks to a relatively low economic base. The rationale behind is the opening of the EU accession talks, which in the past has displayed favourable competitiveness dynamics in the CESEE countries now being part of the EU universe. This is not a cure-all factor and we still think that the government's motivation to enforce the EU-requested reforms will be needed on a fast scale if the economy wants to catch up with the rest of the CESEE. There is a **potential** for **Bosnia and Herzegovina** on a similar grounds, not only thanks to the EU accession prospects and small economic base but also amid the recent improvements in the government forming on all levels, which will fuel the long-neglected reforms on many economic and social levels.

Aside from the mentioned economic environment challenges, **Serbia** carries the biggest mystery given the largest economic potential (not only due to low transition base, but also the overall economic size) on the one hand, and legacy of lengthy period of necessary reform prolongations on the other hand. The economy must at some point transform from being perceived as a hub of cheap labour towards the one creating value.

Bottom line is that at least in the next couple of years the **most developed parts of Adria region** i.e. Slovenia and Croatia will likely continue to **fail to upgrade into high-income economies rankings**. The **rest of Adria region will focus on meeting as much as possible of the EU's restructuring requests**, which will bring some positive results in terms of competitiveness. Average income levels in those economies will benefit as a result, however we do not see those income levels climbing up the income ladder in the CESEE space.

As a result, **for companies in Adria region, we do not see much potential for profitability improvements** (at least not on a general economic level), and a scenario of standstill of profitability is the most likely one. Companies from Slovenia and Croatia carry the burden of limited negotiating power against CESEE peers, which affects their profitability in general. Poor demography trends are also an important element, especially in non-EU Adria countries where emigrations lead to narrowing workforce and bite into the companies' salary costs given the strengthening of workers' negotiating power.

While the approaching EU membership is the key potential for non-EU Adria countries, for Slovenia and Croatia we see the EU's Next generation funds as long as these funds are not perceived as easy money, but rather directed into high return generating sources e.g. establishing competence research centres, motivating nearshoring of manufacturing

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