

Regional analysis SME insight

SMEs Contribute Strongly To Adria Economic Output

Authors:

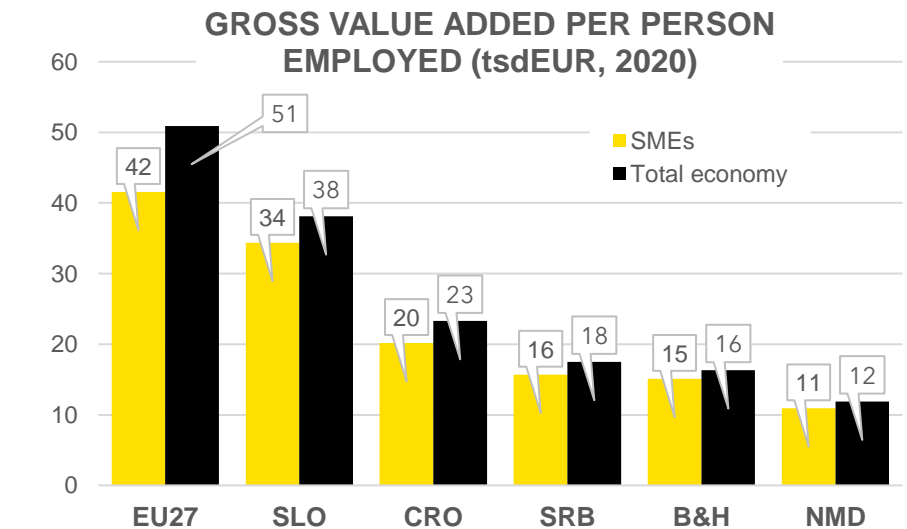
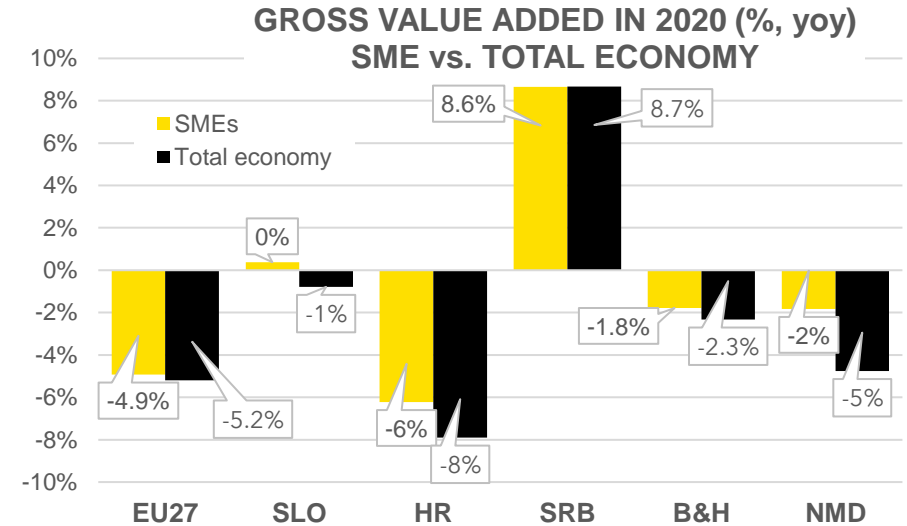
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Small and medium enterprises (SME; the ones with fewer than 250 persons employed) are seen as defining the structure of each economy's activity. Given that majority of employees in each economy is engaged into the SME business, and the economic activity is turning towards a weaker profile in the upcoming quarters, we are testing the Adria region's ability to withstand economic turnarounds via the contribution of SME sector to the overall economy. The data used in the analysis is for 2020 as the latest structural business data published by Eurostat.

Performance during 2020 pandemic. SMEs displayed a mixed performance during the 2020 crisis between countries in the Adria region, however the common flavour is that SMEs performed better than the overall economy in the year of the outbreak of pandemic. We are measuring performance via the Eurostat's Value added at factor cost – the latter is defined as the gross income from operating activities after adjusting for operating subsidies and indirect taxes; value adjustments (such as depreciation) are not subtracted. General understanding is that activity of SMEs is relatively more resilient to economic swings due to their ability to adapt to the latest economic trends – decision-making is faster as well as strategy and market testing being faster, while relatively smaller inclusion into the global trade channels than for large companies with traditional operations in such situation proved an advantage. The profile of value added correlates strongly with the reported real GDP outcomes, with Croatian economy taking the biggest blow in comparison to many other EU countries due its high contribution by tourism to the overall economic output. On the other hand, especially Serbia displayed better profile and the underlying economic resilience, with both SME and total economy marking the similar outcome.

Adria region lags in labour productivity. Official data shows that a) SMEs in Adria region are less productive per unit of labour source compared to the EU27 average, and b) in each country as well as EU27 as a whole SMEs are producing less per single employee than bigger companies. As for a), we see the reasons lying in firms at more developed countries having better access to cheaper funding, stronger R&D practices at nearby big companies allowing for smaller firms to adopt new technologies much easier, better ties in the global value chains (e.g. Germany SMEs are heavy exporters to China), relatively higher shares of skilled labour and more favourable framework to gain funding via various (alternative) channels. Also, Adria region producers are traditionally relatively more included in creating products with comparatively lower added value than in developed economies, with relatively higher reliance on labour as production input i.e. better/stronger inclusion of capital in output creation at more developed economies. As for b), the fact that SMEs are less productive than bigger companies (and resultantly below productivity of the overall economy) is a text book example of the nature of SMEs functioning, which are taking a toll of labour-related challenges (e.g. retention of employees, recruitment of skilled labour, running benefits), weaker cash flow profile and access to funding, administration of multiple business-required operations and marketing (e.g. bigger firms have more money to spend on adds).



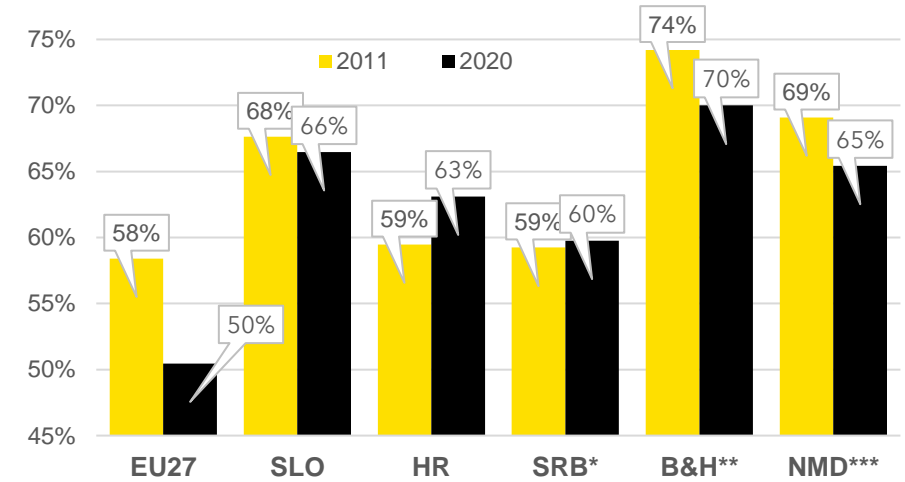
source: Eurostat

SMEs outperform in total economy inclusion. For measuring the importance of SMEs, we include also total turnover - turnover comprises the totals invoiced by the observation unit during the reference period, and this corresponds to market sales of goods or services supplied to third parties; it includes all duties and taxes on the goods or services invoiced by the unit with the exception of the VAT. Comparing the inclusion of SMEs on a multiyear period shows a mixed performance within Adria region, however more importantly is that contribution of SMEs in both total turnover and total value added has strongly outperformed that of EU27 during the period 2011-2020. In other words, in the EU27 contribution of SMEs to total turnover and total value added has declined severely, signalling stronger contribution in both measures by bigger companies.

We understand that SMEs performance in Adria region mirrors benefits of a multiyear period of cheap funding, strong economic performance both at home and the key trading partners (i.e. nearby EU countries), stronger involvement in foreign trade channels, economic bloc integrations (e.g. Croatia's EU entry), doing business environment benefits of regulation relaxation and digitalization working in favour of higher productivity in general. The key drags came from the need to restructure traditional operations until 2010s, reduce reliance on overindebtedness and negative demographic dynamics especially with losses of skilled labour.

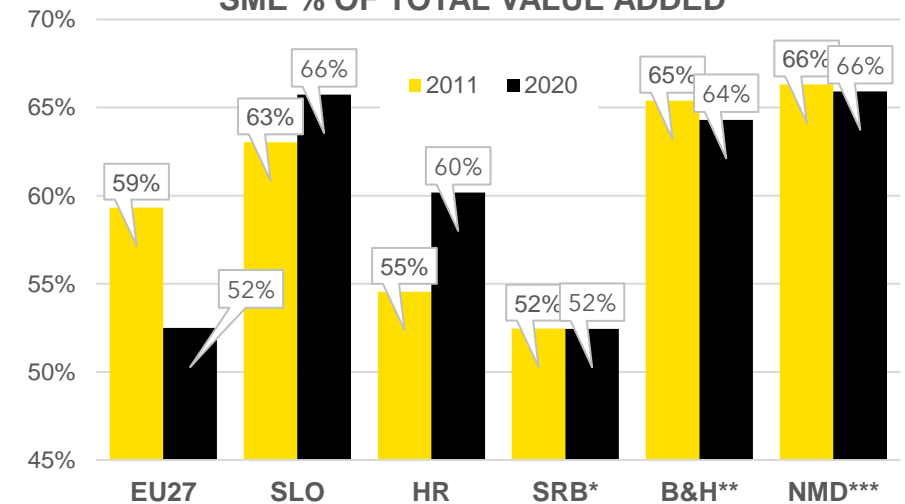
The presented movements and the current contribution of SME business are the key reasons why we do not see a material drop in the real GDP development for 2023. Indeed, this goes hand in hand with our views on foreign trade developments, where the regional economies have materially reduced their foreign trade imbalances since 2000s, with goods exports now between 60%-240% above levels in 2007 (i.e. the last year before Global Financial Crisis).

SME % OF TOTAL TURNOVER



source: Eurostat

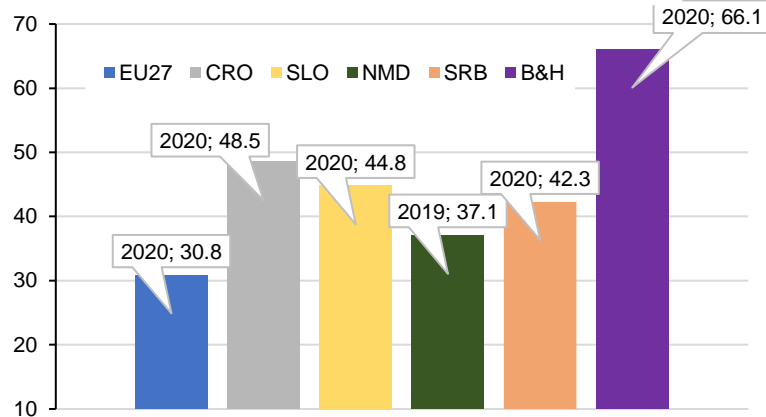
SME % OF TOTAL VALUE ADDED



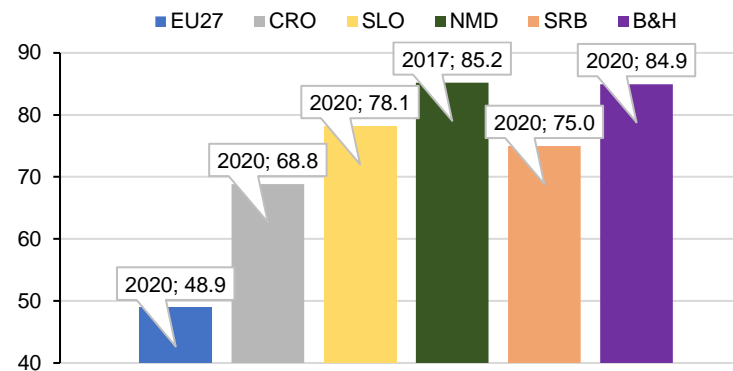
*instead of 2011, earliest data is for 2019; **instead of 2011, earliest data is for 2014; ***instead of 2011 and 2020, presented is 2013 and 2019 data

Highlights

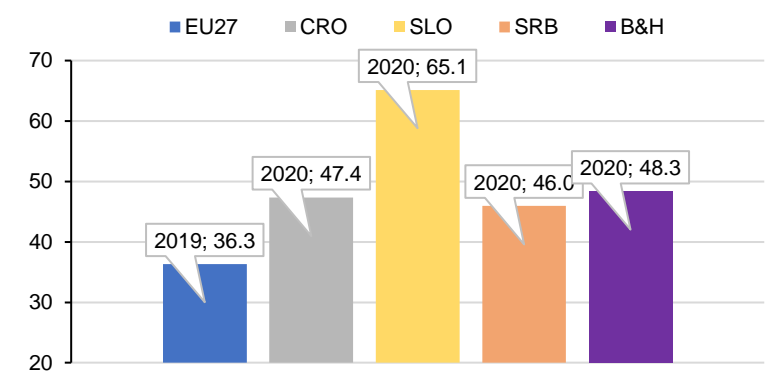
SME % OF TURNOVER IN MANUFACTURING



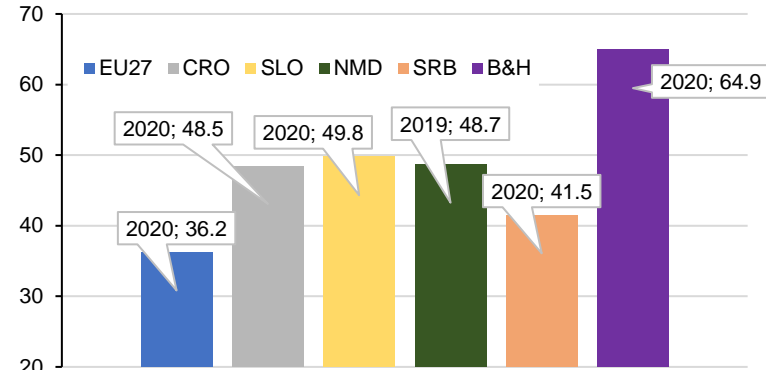
SME % OF TURNOVER TRANSPORTATION & STORAGE



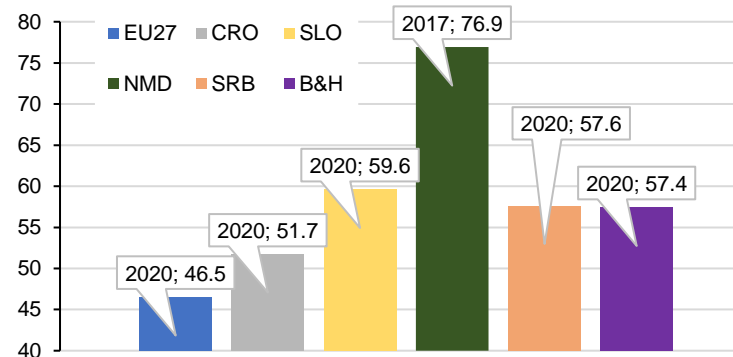
SME % OF TURNOVER IN INFORMATION & COMMUNICATION



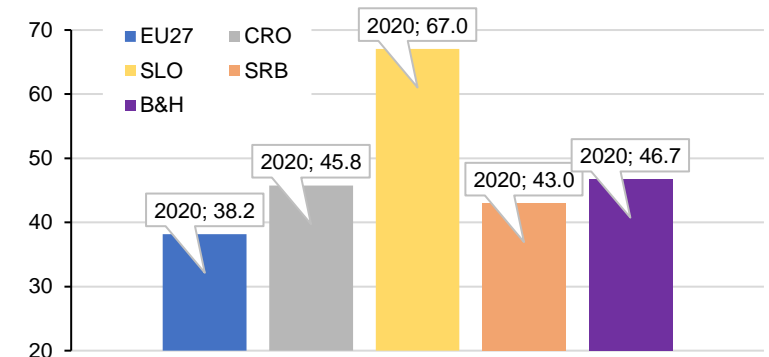
SME % OF VALUE ADDED AT FACTOR COST IN MANUFACTURING



SME % OF VALUE ADDED AT FACTOR COST IN TRANSPORTATION & STORAGE



SME % OF VALUE ADDED AT FACTOR COST IN INFORMATION & COMMUNICATION



source: Eurostat

Observing three activities which we see as a good balance of overall economic output contribution and value-adding generation - information & communication, transportation & storage and manufacturing - in 2020, we can see that SME's share of turnover or gross premiums written in Adria region in each country shows higher share vs that of EU27. Compared to information & communication sector, sectors of transportation & storage and manufacturing show more pronounced positive difference against the EU27 averages given the combination of less highly-skilled workforce needs in the named sectors as well as generally lower salary burdens for employers. On the other hand, SME's share of value added at factor cost was less profound in the region vs EU27's average.

Observing the COVID-19 pandemic effects, we see that SMEs in information and communication actually showed an increase in 2020 value added at factor cost, reflecting both the globally increased demand for the sector's products (e.g. working from home) as well as the sector's inherent ability to work remotely. In this respect, the other two sectors in our observation saw a decline in value added at factor cost in 2020 vs 2019. In manufacturing, the decline was mainly centred around lower general demand, which forced many shutdowns of machinery and reduced work-week days. In transportation and storage less people travelled, due to smothered demand and/or epidemiological measures, with the same time supply-chain issues emerged (impacting industry).

Our outlook for economic activity for 2023 is directed towards mild recession for Slovenia and Croatia alongside sharp slowdown in economic growth for Serbia, Bosnia and Herzegovina and North Macedonia. In 2024, a mild economic recovery is assumed on the back of easing fight against inflation and anticipation of better investment outlook driven by clearer view on cost of money mid-term profile. We see **SMEs going along the same pattern as the rest of the broad business output dynamics** in the upcoming years i.e. any material upgrades in the SME area are likely put on pause for a while.

The first fact to mention against the above-described backdrop is that the current environment does not favour implementation of unproven practices and technologies, which is typical for SMEs. Secondly, SMEs' access to funding will be one of critical elements for the business development going forward as they are traditionally facing stumbling blocks to get funding, and capital is now costlier and less available due to central banks' fight against inflation. This only adds to funding limitations at bank systems originating from risk management-related regulation, and even more elevates the importance of developing crowdfunding platforms and venture capital funds, which are in any way in early stages of development locally. Another element to work on is the customers' perception of SMEs' business, with SMEs being typically perceived as riskier due to business size. Needless to mention that this is now even more important when producers' sentiment is severely aggravated by central bank tightening and geopolitical concerns.

Although initiatives to improve business registration processes are already in place, there is an ongoing further potential for the government and non-government support to create a strong framework for SMEs to meet their open needs, with already good examples of setting up of entrepreneurial networks and start-up hubs i.e. key elements benefiting the SME set-up and growth. Another important element in this respect is the demographic requirement, with SME development requiring enough of skilled labour, being challenging against the backdrop of negative demographic trends.

In a challenging economic environment in at least next couple of quarters, we see less potential for SMEs to develop or strengthen inclusion in global trade channels, which is always a key target for the regional SMEs to improve their value added generation and enhance development potential via more investments and different know-how implementation. Needless to mention that failing to include in global trade much stronger also leaves the local SMEs less exposed to challenges such as global competition.

Bottom line is that we see the current status of SMEs allowing for the regional economies to avoid deep economic contraction as hitherto SME involvement in the regional economies came along reduction on past tradition of overreliance on a smaller number of big producers. The key target for the future will be to increase value added per person employed as part of the general convergence path.

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