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BACKGROUND REPORTS

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DEVELOPING A FAVOURABLE BUSINESS ENVIRONMENT: LESSONS FROM THE EXPERIENCE OF ITALIAN FIRMS IN THE REGION OF TIMISOARA, ROMANIA

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1. Introduction

The principal aim of the paper is to assess which are the key factors for developing a favourable business environment which could support high growth rates in the region, thanks to the attraction of new foreign investments, the maintenance of the firms already present in the region and the development of a network of local firms with a good level of competitiveness in the European and in the world markets.

Given the high number of firms involved, the experience and the strategies of the Italian firms in the region have been analysed in order to develop some policy guidelines concerning the implementation measures directed to create, in the medium and long-term, a favourable business environment. It is worth noting, that the development of a favourable business environment is increasingly becoming a crucial aspect in sustaining economic growth. An attractive location draws foreign and innovative firms and gives existing firms an incentive to invest. This, at the same time, increases the amount of resources available to the public authorities and improves the general business environment. These feed-back effects are at the heart of the growing concentration of firms in local clusters which is one of the characteristic features of the contemporary economic landscape (Krugman, 1991). However, the definition of the business environment cannot be so easily identified as this concept is the result of many different aspects such as: institutional, legal, administrative and cultural factors (both at a national, regional and local level), market rules, infrastructures and firms behaviours. With regards to the national factors, the country appears to be on its way in the process of accession to the EU as recently stated in the EU Report on Romania's progress towards accession. These advancements greatly improve Romania's attractiveness, promoting economic stabilisation, defining the steps to be taken in order to decrease the administrative burdens on firms and the legal barriers to entrepreneurship. However there are some regional and local factors that are equally or even more important. These aspects will be analysed in this papers.

2. Motives and evolution of the investments by Italian firms in the Timis and Arad counties

2.1 The push factors

During the nineties the North-western area of Romania received a large numbers of investments from Italian entrepreneurs. This flow of investments brought new capital and technology to the area that is now, also thanks to this flow, one of the most dynamic economic areas in the country. In order to investigate why so many Italian firms transfer part of their value chain in the area we have to refer to the reasons that tempt firms to internationalise (push factors) and to the motives that attract them to the region (pull factors).

A variety of different studies has analysed the motives for foreign direct investments (FDI). According to the goals pursued by firms foreign direct investments have been grouped into two main classes (Dunning, 1993): market-seeking and cost-seeking investments. The first set of investments concern those businesses that invest in a foreign country with the aim of better services for the local customers. In this case, investments generally involve downstream activities and are chiefly targeted to large or fast-growing markets.

On the other hand, cost investments are aimed at enhancing the competitive position of firms decreasing the total cost of production for them. Therefore, these investments are above all targeted toward areas characterised by a low cost of labour or sometimes by a low cost of raw materials and of intermediate products. Recent studies and surveys (see Lankes and Stern, 1998) have clearly shown that market seeking investments are largely predominant among the investments in the central European countries, but, at the same time, the characteristics of the FDI vary greatly according both to the host country's characteristics and to the nationality of the investments. These exceptions apply perfectly to the Romanian case (and the Timis-Arad counties even more) where Italian firms realise mainly "vertical investments" i.e. cross-border relocation of the value chain, driven mainly by factor costs motives. The pursuit of this strategy by Italian firms during the nineties is not surprising.

The majority of Italian SMEs are to be found in sectors with a standard technology. These firms produce intermediate and final consumer goods. These sectors are generally positioned in the maturity phase of the product's life cycle and are, therefore, growth-restricted and with a high price elasticity. Consequently, Italian corporations operating in these sectors are heavily exposed to international competition and, in particular, to competition from companies belonging to developing areas with low labour costs. The solutions found by Italian firms confirmed their capacity for adapting to the new environment. This required in-depth reorganization and the search for new forms of organization, both at the local and international levels. The increasingly stiff price competition in the newly-industrialized countries compelled companies to change their strategies, pursuing innovative policy in term of technologies, marketing and distribution strategies and realizing production decentralization on an international level. Moreover the process of currency stabilization induced by the Italian participation to the project of European Monetary Union has encouraged firms to expand on an international level. The adoption of the Euro and its relative strength have pressed Italian firms since the beginning of the process in the middle Nineties to relocate low-value activities in low cost area in order to keep up with international competition.

Finally, in the case of Italian firms coming from the Northern area, and from the Veneto region more specifically, the structural shortage of labour force, characteristic of the economic situation in the Nineties gave them an incentive to look for other existing sites of production

Data shows (ISTAT 2002) that this process of international growth is taking place on a large scale in Italy, where local SMEs have expanded their presence through the establishment of foreign direct investments. Recent studies (Majocchi and Zucchella, 2003) tend to confirm that growth is an effective option for Italian firms in order to increase their international position.

However, the average small size of firms is not the only feature of Italian firms, which shows a high level of geographical concentration in areas generally defined as "industrial districts". This model has been in some way replicated in the region of Timis and Arad. The Italian presence in the area is for the most part made up of small and medium-sized corporations. Large Italian corporations are only marginally present. As there are predominating small and medium-sized Italian corporations in Romania, this explains why there is a relatively little acquisition of local corporations. Moreover, management literature has clearly shown that one of the main limiting factors to the international expansion of small firms is the shortage of managerial skills. Within small firms decision-making takes place on an individual level, therefore it is likely that the decision to go international relies on decisions taken without a proper evaluation of the alternatives. In this context the personal relations developed within the domestic market with managers of suppliers, clients and competitors strongly influence these kinds of decisions. When the first-mover firms transferred part of the activities to Romania, other companies followed. Furthermore, if we take into account information costs, SMEs are at a disadvantage compared to large firms also regarding their capabilities in collecting information on the new business environment. This situation increases the uncertainty surrounding the investments. As for small firms the proportion of resources committed to a foreign direct investment is quite large, the risk also seems larger for SMEs than for big firms. The concentration of firms in a restricted area helps firms to save on search costs and to decrease the uncertainty surrounding the investments. Finally, to go abroad requires adaptation and modification in terms of management, organizational routines and even of marketing and production technologies. All these modifications incur costs to the firms which would be hard to sustain given their limited resources. As Italian firms were mainly resource seekers, firms did not rely on exports as the first means of acquiring knowledge of the new environment. Therefore, knowledge was gained through the sharing of information not only within the firm but within the network of companies already cooperating in Italy.

In the case of Italian firms in the region of Timis the process of internationalisation must be interpreted as a development that regards not only one firm but often an entire network of firms. The international experience of certain elements of the network is then passed to other firms. Stable and continuing cooperative relationships within networks help the sharing of information within the network. Cooperation not only facilitates the exchange of information, but also contributes to the spread of imitation processes among the firms, and consequently to replicating a concentration of firms in the Romanian area. In analysing the internal process of decision making that convinces the firms to go international, many firms affirm that an important factor is the existence of other partners or competitors following the same route.

2.2 The pull factors: the attractiveness of the area

But why do so many Italian firms locate specifically in the region in question and not elsewhere? A useful tool of analysis can be the well known Porter (1990) diamond that defines the factors at the heart of competitive advantage of a local system. According to Porter’s definition the set of factors are the following:

1. Factors conditions
2. Demand conditions
3. Related and supporting industries
4. Firm strategy, structure and rivalry

Factors conditions and, more specifically, low labour cost were at the source of the first wave of investments in the area. According to OECD data, in order to measure wage differential, we can put average labour cost in the manufacturing service equal to 100 in Romania in 1995, then the corresponding value of cost for other countries in the area will be: 288 for Poland, 231 for Slovakia and 107 for Bulgaria. Moreover, the Romanian labour force and more specifically that the region of Banato (which include the Counties of Arad, Timis and Bihor) show a good level of skill. This facilitates the productivity of investments in sectors such as the mechanics, clothing and footwear industries. Moreover, the chance to use the *outward processing trade* (OPT) i.e. to have duties exemption for those processes temporary exported from the UE was used by Italian firms that used - and still use - labour intensive process in the area.

The second aspect within the category of Factors conditions that promoted investments in the area was the proximity of the region to the European market. The strategic position of the Banato Crisana district (the region around Bihor, Arad and Timis) was surely an important aspect in the choice of the first Italian firms that chose to locate in the area.

However, it is worth noting that geographical proximity is not the only conditioning factor which directs investment from Italy. Even more crucial was the cultural aspect. In a recent empirical survey of the presence of companies from the Veneto region the foreign department of the Chambers of Commerce of the Veneto region (Centro estero veneto, 2003) concludes that the main points in common between the two areas (international vocation, economic dynamism, high rate of small and medium firms) greatly help the process of international transfer of the intermediate stages of production. The fact that most of the firms are SMEs is, in this respect, essential. For those firms the process of internationalization is a big step forward that greatly consumes scarce managerial resources. The cultural proximity in terms of both economic characteristics, language and cultural attitude significantly helps small and medium-sized firms in the process of adaptation to the new environment contributing to the process of agglomeration in specific areas.

If factors conditions have their prominent role in the first wave of investments from Italy, demand conditions and the development of a network of related and supporting industries then contribute to the strengthening of the process. One of the main features of the Italian industrial organisations has always been the high number of production processes that have been subcontracted out. This organisational device allows firms to remain small in scale and at the same time requires a high level of coordination between buyer and sellers in order to efficiently organise the production process. Market-like coordination mechanism substitutes the hierarchal mechanism typical of large integrated firms. This high level of coordination, not only avoids vertical integration, but also explains the high level of fragmentation within Italian industrial districts. However, when cost factors pushed some firms in the value chain to transfer their activities this forced others to follow. In order to obtain close vertical coordination continuous face-to face interaction and therefore geographical proximity was necessary.

The same applies to horizontal relationships. The limited scope of firms implies not only close supplier-buyer relationships but also intense links between companies and firms in related industries. Once again, when the client moved to another geographical area supporting firms were also encouraged to transfer in order to quickly and efficiently supply direct and support services.

According to recent estimate an increasing number of Italian investments in Romania relate to the service sector (trade and distribution, banking and finance). This point is in some way crucial for the future development of the area and it will be developed further in the final section of the paper.

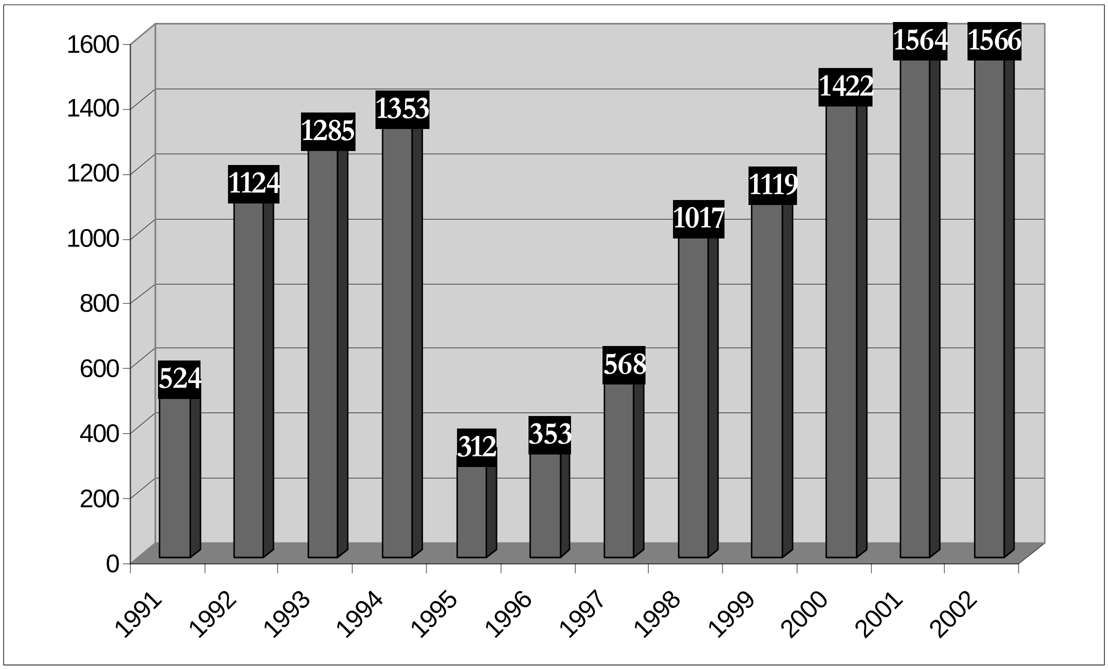
The final point that explains the competitive potential of a geographic area is the level of rivalry within the firms acting in the area. Porter (1990) greatly emphasizes the function of competition among firms in enhancing innovation and international competitiveness. In this respect the area of Timis and of Arad replicates the hard competitive environment that is common to many Italian industrial districts and that leads the businesses located inside the district to increase their average level of productivity (Banca d’Italia, 1999).

With respect to this final point Enright (2002) underlines that within successful clusters firms tend to cooperate in some respects and to compete in others. Some activities such as lobbying, foreign market research participation to trade-fairs and so on are sometimes realised in a cooperative way among firms while innovative and marketing activities are carried out in a purely competitive setting. This aspect is particularly relevant for the success of clusters and leaves space for effective regional policy.

3. Main trends from mid-nineties till now and contribution to the host region’s economy

The evolution of the Italian investment in the region shows a clear pattern that can be depicted as a two stage development. In the first stage from the very beginning of the nineties to the second half of the nineties there was a first flow of investments in the region. As always happens when a new economic phenomenon takes place, this first flow was characterized by a low level of strategic planning by the firms. After the stagnation period, FDI flows from Italy grew with a sustained pace up to the present level. At the beginning of the year 2003 the number of Italian firms in Romania was 12.236.

Figure 1. Italian investments in Romania 1990 – 2002 (numbers of firms registered)



Source: Chamber of Commerce of Timisoara, Regional Development Agency, Romanian National Bank

In terms of the number of registered enterprises Italy is the first investor in Romania whilst in terms of capital invested Italy is well behind some other countries such as Germany. This fact is due to the dominance of SMEs among Italian investors that typically invest smaller amounts of capital than large firms. It is due to the tendency, typical of Italian firms, to operate with a high debt-capital ratio thus depressing the nominal value of investment when measured in term of subscribed capital.

Given the low level of capital required to open a new venture in Romania many Italian entrepreneurs acted with an option-like approach. In many cases, a new firm was initially settled with the idea to test the real possibilities of developing profitable economic activities in the region. The period 1995-1998 was a turning point and saw a sharp reduction of Italian investments for the difficult macroeconomic conditions of the country. The recession of 1997 to 1999 affected the entire SME sector in Romania and Italian investments also slowed down. In some way this crisis helped in selecting investments in the area. The firms that remained in the region from then on showed a higher level and a more structured commitment. Higher inflows, in the region and in the country have been registered since 1998 following the last liberalisation and stabilization shock, but the real boom started with the new millennium.

The national trend is in some way mirrored in the regional trend of Italian investments in the two Counties of Timis and Arad.

Table 1. Table 1: Italian Registered firm in Romania and in the counties of Timis and Arad

Year	N. of registered firms in Romania (flow)		N. of registered firms in Timis (stock at the end of the year)		N. of registered firms in Arad (flow)	
	Nr.	%	Nr.	%	Nr.	%
1991	524	4,2%	==	==	26	2,6%
1992	1124	9,1%	==	==	42	4,2%
1993	1285	10,4%	==	==	55	5,5%
1994	1353	10,9%	==	==	93	9,2%
1995	312	2,5%	==	==	31	3,1%
1996	353	2,9%	==	==	27	2,7%
1997	568	4,6%	==	==	37	3,7%
1998	1017	8,2%	==	==	80	8,0%
1999	1119	9,0%	783	==	99	9,8%
2000	1422	11,5%	==	==	148	14,7%
2001	1564	12,6%	==	==	148	14,7%
2002	1566	12,7%	1448	==	157	15,6%
2003**	159	1,3%	==	==	63	6,3%
Total	12366	100%	1638*	0,00	1006	100%

Source: Ministry of Justice, Arad and Timis Chambers of Commerce
* = at the end of 2003
**= provisional data

Looking at the experience of Italian firms in the area at least three different strategic approaches can be identified (Majocchi, 2000).

The first model singled out refers to the case of Italian corporations that have chosen to create brand-new corporations or a subsidiary in Romania.

Italian companies have clearly distinguished the supporting but strategic activities such as marketing, business relations management and design and marketing which remained in the home country from production activities – more sensible to cost – that have been entirely or partially decentralized to Romania. This model of expansion is quite a standard one and has been followed quite extensively by large corporations. But, compared to the strategies usually observed where relocalisation processes are being implemented (Dunning, 1993), this strategy stands out insofar as the firms seem to move towards areas where the existence of other companies allows some of the typical processes implemented within the home country to be replicated. These corporations, that we can call the leader-corporations, have direct access to the consumer market, mainly in the EU, have a proprietary brand name and consequently have developed sometimes marketing and distribution functions. The firms in Romania generally both produce and co-ordinate sub-suppliers. The relations between the leader-company and the partner corporations reproduce the relations originally developed in Italy but on an international scale.

On the other hand, there are corporations which have transferred the value chain entirely to Romania. These companies have been faced with a difficult situation due to stiff international competition. However, among these corporations some have seized this chance to achieve a strategic expansion, by acquiring a more autonomous role. These firms were able to become a reference point for a series of other corporations in Romania. In so doing, they perform the role of leader-company in their new target district, a role they were unable to perform in their district of origin, by diversifying production, increasing the number of clients and reference markets, or directly penetrating target markets with autonomous trademarks, thus expanding merchandising and marketing strategies.

On the other hand, there are firms that only compete on prices generally with few market relations and no market power. These firms are now considering the possibility of moving towards an area where the cost of labour is even more favourable such as the East part of Romania or even Moldova and Ukraine.

The distinction between the hub strategy (the first two models) and the last one is a relevant one when we look at the stability of Italian FDI in the region. In the words of an Italian entrepreneur: "*Italian investments are of two kinds with wheels and without them*".

The level of commitment is very different. In all cases the presence of foreign firms allows a transfer of technology and competences that contribute to the upgrade of the technological capabilities in the regions. The level of embeddedness - in the sense of intense relations with other firms located in the area - is however very different. While the last model has a very low impact aside from an important pedagogical function, the other two are much more rooted in the economic environment.

These behaviours of Italian firms have surely had a relevant impact at least along three lines:

1. The Italian firms tendency to subcontract also remains when Italian firms move to the region. This slowly helped the creation of a network of firms also with Romanian counterparts, thus promoting the diffusion of an entrepreneurship culture in the region.

2. The high intensity of SMEs helps to greatly mitigate the unemployment problem in the region. Typically, SMEs all over the world count for a large share of employment and the large number of minor firms keep the unemployment rate at the very low level of less then 4%, very close to the frictional level and roughly half the national average.

3. As Hunya, (2002) stated: "One peculiar characteristic of investment in Romania is the high an increasing level of greenfield investments mainly of small and medium size companies located along the Western border and engaged in processing. This helped to increase exports over the last three years, although the structure of exports has not improved much but remained confined to textiles, clothing and leather goods as well as metals and chemicals". With the exception of chemicals but with the inclusion of trade and distribution, Italian investments are mainly concentrated in those four sectors with clothing, footwear and furniture covering 37% of the total export in 2001 (OECD 2002).

4. Cluster characteristics

The general picture is one of an area with high potential and that in certain aspects already fits in with Porter's widely accepted definition of an industrial cluster i.e.: "a set of industries related through buyer-supplier and supplier-buyer relationships, or by common technologies, common buyers or distribution channels, or common labour pools." However, unlike typical clusters in the Timis-Arad area there is not a clear industry specialization even if the first push from the footwear and the clothing industries maintains an important role. Moreover, Italian scholars (see Beccattini 1990) have emphasized the social aspects of an industrial district in Italy underlining that industrial districts are embedded in the local community. This social glue is a very important feature and as all social processes it requires a long process that can be developed through time. Social interaction between participating firms facilitates cooperative ventures among firms and therefore strengthens the competitive position of the cluster. In this respect the fact that a large part of Italian investment in the area comes from the Veneto region surely reinforces and facilitates the social cohesion process at least for the majority of foreign entrepreneurs. The Italian community is well rooted in the region and even if a strong representative association is not in place, many common but still scattered initiatives have been developed.

However, geographical clusters can be very different in terms of, density, social cohesion, level of activity, vitality, industry concentration, geographical span of the sales and stages of development.

In this respect Enright (2002) put forward a general classification of clusters according to their stage of development that can be useful to analyze the current stage of the Western area. Enright distinguished between 5 categories of clusters:

1. *Working clusters*: a well developed industrial district
2. *Latent cluster:* a cluster with an high number of firms but where the level of interaction among them is still low due to lack of trust, low cooperation and high transaction costs;
3. *Potential clusters*: are those that present good opportunities and where some key elements of an effective cluster are already in place.
4. *Policy driven clusters* are those where the role of public support has been overwhelming in the creation process of the cluster
5. *Wishful thinking* clusters. These are uncompleted clusters where the role of policy has failed. They are mainly concentrated in the high-tech sector.

The scale goes from the least effective clusters, the so-called wishful thinking districts, to the real and successful working clusters. The case of Timis and Arad area is clearly in the middle between a non performing area and a successful district. On the one hand, the development of the area has been facilitated by the injection of capital, technologies and entrepreneurial culture and capabilities from outside. The process has been mainly promoted by an external push. Nonetheless, these external capabilities and capitals have been attracted by local peculiarities that successfully mixed with the external factors. The Banato Crisana area is now a region with an high potential in order to reach the stage of a working clusters. The area currently presents some key features typical of a district:

- a high numbers of firms, mainly SMEs;
- a high level of business relationships mainly based on sub-contracting agreements which involve not only foreign firms but also local firms most of them recently created;
- some kind of cooperation for the most part among firm of the same origin;
- an intense and growing network of firms operating not only in specific industries (mechanical, footwear and clothing, automotive) but also in supporting sectors
- a high level of international integration as the region is second in the country for attracting foreign investments (after the capital city Bucharest) and third in terms of export;

5. Main difficulties encountered in the host country

On the basis of the interviews with Italian investors administrative inefficiency can clearly be seen as the main hurdle to economic activities. All business entrepreneurs complain about the weak and confused regulatory framework which creates an uncertain and costly business environment. More specifically firms criticize:

- the constant changes of legal acts that confuse the legal environment and increase administrative costs; the consequence is an institutional setting lacking transparency. Firms have problems just keeping up with the rules. Overall, there is a consensus among Italian firms about the need to simplify and stabilise the business environment. This will allow firms to carry out medium and long term plans more efficiently.

- the numbers and the frequency of controls from a large number of different sources that obliges firms to do a lot of paper work which slow down economic activities.
- on many items (custom, regulation, sanitary rules…) firms complained about lack of coordination among regional and national authorities;
- a general lack of business information and support. Most of the firms interviewed – mainly small and medium firms - rely on information passed through by other firms. If this process were to promote the concentration of Italian firms in the area it could be a hurdle for future development. According to Italian entrepreneurs it is not always clear which is the source to rely on for the information even if many mentioned the experience of Antenna veneto as a significant experience to develop. According to those questioned some also rely on Italian banks placed in the region for information. Although this channel is still at a very early stage, it seems a promising tool for a more structured presence of Italian firms in the future.
- a new generation of middle managers and skilled labour force is emerging but the process is slow and should be reinforced, the role of training is crucial and should be strengthened.

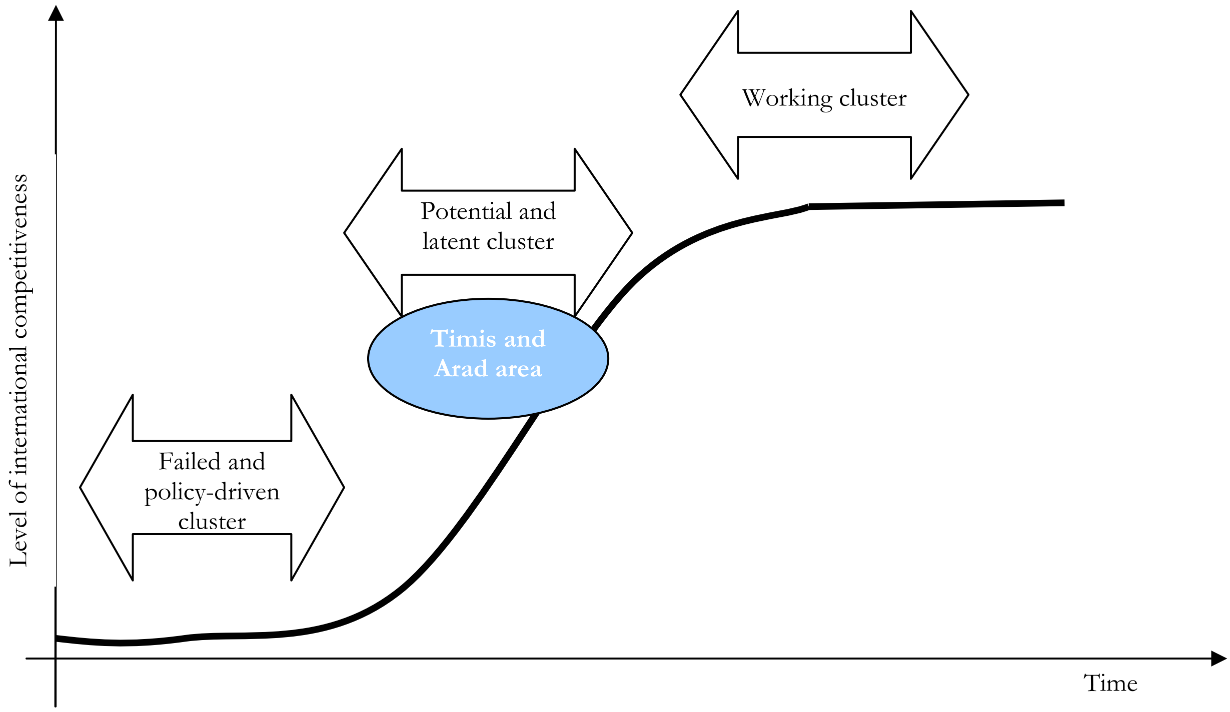
6. Recommendations for local policy makers

The Timis-Arad area clearly has some features that resemble those typical of a cluster. Nonetheless, the central question is the cluster sustainability i.e. the ability of the district to compete in the international arena over a long period of time.

Just now, but even more so in the future, the region should consider that its regional competitors are not the less developed areas of Romania or the capital city. The competitive threats to the region come in fact from other areas located in central Europe such as Slovakia, Poland, Hungary that are attracting new investments in high value activities but also from far regions where the cost of labour is already less significant such as China and the South East Asian countries.

In the Tims-Arad region foreign investments has surely played a pivotal role. Consequently the role of foreign capital remains fundamental for the future development of the area. In this respect the goal of the region should be two-fold: to maintain and eventually increase the present level of attractiveness (according to the Timis Chamber of Commerce, Timis average frequency of foreign registration is roughly 40 new firms per months) and facilitate a progress of upgrading the role of foreign firms in term of capabilities, level of human resources, responsibilities and internal investments.

The medium term path that Romania and more specifically the region of Timis and Arad should follow is clear: to develop from its existing strengths towards a more sophisticated pattern of production. In this way the area should be focussed on moving from the state of a potential cluster towards a successful one. The task is not an easy one.



With regards to Italian firms, the main limiting factor seems to be that Italian companies still tend to maintain high-value activities in the headquarter or in the mother-units back to Italy and to transfer low value activities, mainly production to the region.

If low labour cost will remain the driving force behind the internationalisation, foreign investment will be condemned to move towards other neighbouring areas. As productivity growth and as Romania approaches the accession to the European Union economic forces will drive wages up. Labour intensive firms relying only on cost driven strategy will be forced out of the region. In fact, first signs of this development are already in place with some firms – mainly in the footwear and clothing industries already exploring the possibility of moving to less developed areas such as Moldova, Bulgaria and even Ukraine.

Therefore, in order to be an effective cluster the area should evolve towards a third stage. The first phase, from the fall of Communism to the middle of the Nineties, was the least structured but nonetheless it contributed to create entrepreneurial culture in the area. The second phase consolidated the process by attracting new more stable and increasing investments. The third stage should concentrate less on quantity and more on quality.

The goals of the region should be to attract new firms and to promote the evolution of the existing units towards high quality investments. These investments have been extensively studied recently and are generally known as “centre of excellence” (Birkinshaw and Hood, 2000). The term defines an organisation units within a multinational corporation (large or small) with high values capabilities and explicitly recognised within the firm as an important source of competitiveness.

It must be noted that the development of high quality investments in the area is positive both for the investing firms and for the region which attracts this kind of investment. Recent management literature (see for example: Frost, Birkinshaw and Ensign, 2002) has clearly shown an overall trend in multinational corporations to disperse activities more globally not only with regard to production but also to the strategic activities such as innovation distribution and marketing. This dispersed configuration allows firms to follow more closely differentiated markets around the world and to more easily exploit and leverage knowledge disseminated in a local business context. On the side of the receiving cluster the location of a centre of excellence in an area brings higher values activities, higher paid and skilled workers and therefore increases the transfer of knowledge from the headquarters to the unit located in the region. Moreover, what is most significant is that these high values units generally present a higher level of embeddedness or, more explicitly, tend to create intense local business relationships. These kind of local networks require a long time to be fully developed but once in place are location-specific and therefore are more locally rooted. This local network creates what has been defined as "leading edge clusters" i.e. an aggregation of complementary highly innovative firms with a good international competitiveness (high export rate). The future accession of Romania could be a strategic opportunity for this change. Foreign firms can consider their Romanian base as a foothold towards the high growth countries of Central Europe and the Timis and Arad strategic position is in a privileged location for supporting this strategy.

The present network of foreign and local firms represent a good starting point for achieving this goal; there are some hurdles still to be overcome and a good local policy could support and speed up this process.

Moreover the region has other strengths that can be built upon:

1. Timis County has a skilled labour force and the region is known for its long tradition of research and university teaching. There are 7 Universities between Timisoara and Arad both public and private;

2. Italian firms are presents but there are also important investments from Germany in mechanics and in the automotive sectors but also in software and electronics. Software houses and companies such as Alactel or Siemens rely on the highly skilled engineers and software designers that can be found in the area. So the industrial landscape is characterised by a balanced mixture of both minor and large firms and of both traditional activities (footwear, clothing), heavy mechanicals (automotive) and new technologies (software and electronics).

3. The area has an international aptitude due to its location but also to historical heritage. Thanks to the contribution of different communities, to inter-regional immigration and foreign investors the region is a multicultural, pluri-ethnic and multi-confessional space (RDA, 2002) where different communities live together peacefully and this attitude greatly contributes to the open-mindedness of the people there. Technical skill together with an international vocation constitute an important point of departure towards the creation of a successful international cluster.

Even if cluster commonly emerge in a spontaneous way, national and local policy can reinforce its development. With regards to the case of the West region both levels of government can greatly improve the business environment.

What does the region need? Using the terminology of a local practitioner: "*We just need three things: rhythm, strategy and vision*"

6.1 Local level

As an introduction it must be noted that successful regional areas are never the fruit of political will alone. Regional and local policy can only help to reinforce industrial strengths that are already in the region. A good local policy is always a "light" policy that aims at facilitating the work of business operators.

Given that, and taking into consideration the strengths and weaknesses of the region, the local economic policy could be developed along the following lines:

1. Regional policy should clearly indicate which are the top priorities in the development of the area. Defining some key strategic points allows all the local economic actors to better plan their activities bearing in mind the overall process. It is useless to say that economic targets cannot be an indefinite number, the strategic goal should be no more than two, maximum three over a medium-long period. Moreover, if the economic goals set by the institutions are well understood and agreed upon by local actors then the entire process will grow in credibility and therefore be reinforced.

2. Institutional and economic goals do not appear by chance. All local institutions, firstly firms, but not only firms, have to be involved in a process of definition of the targets. The history of a wide range of successful clusters around the world shows that a key element in economic growth is the high level of networking and partnership between institutions. These institutions range from companies and local authorities to educational institutions (universities, but also technical schools), entrepreneurs and firms associations, foreign investors associations, Chambers of commerce, financial institutions, trade unions and regional developments agency.

3. Following the previous arguments a possible goal of the region of Timis and Arad could be the attraction of new investments and the upgrading of existing investments (both from foreign corporations and from local firms) creating a business environment which promotes the development in the area of high value activities (research activities but also marketing, distribution and managing activities) not only production. It is clear that this objective is subordinated to the hypothesis that Romania will join the European Union and will therefore be part of a very large integrated and competitive market in the near future, possibly in 2007 as predicted by recent agreements.

4. Following previous points, the goal of the area could be summed up in the following way: develop centres of excellence in the area the will drive regional competitiveness. This target can be expressed in two ways. On the one hand the goal is to allow existing activities in the electronics and software industries to develop further. With respect to this goal the co-operation of technical schools is obviously crucial. Nonetheless, the area has attracted a large number of Italian firms in the footwear, clothing, light mechanics and furniture sectors. It would be unwise not to leverage on this immense network of capital, entrepreneurship and commercial capabilities. If these firms will rely only on cost saving policy all this wealth will be condemned to disappear with great damage to the area. The central geographical location of the area is in this way strategic. Italian firms located in the area can slowly move from just production centres to marketing and distribution centre not only for the local market but also for all of Central Europe. Recently, a comprehensive study by Manrai, Manrai and Lascu (2001) ranked the countries of Central and Eastern Europe according to their overall attractiveness looking at the demand potential and at the logistics of marketing operations in the country. According to this research Romania was classified in the most attractive group together with countries like Czech Republic, Hungary, Poland, and Slovakia.

5. If the region wants to attract high quality human resources the problem of quality of life an environmental protection should be taken into consideration. Talented people make their choices according to wage offers but also according to the appeal of the location.

6. The interaction of quality and quantity of labour force, the quality of life and the general level between the economic, social and institutional actors in the area is at the heart of what has generally be defined as "social capital" which is the truly inimitable competitive advantage of any successful clusters.

Given these general medium and long term goals the following list of intermediate goals should be considered:

a. Concerning legislation and administration the project of the "one stop shops" should be encouraged further. This office should gather the maximum number of possible offices that entrepreneurs should visit on a local basis. Moreover it should direct firms towards the reliable sources of information. The centre should be aimed at facilitating the registration of new firms fulfilling all the required legislative criteria and at giving basic information. The centre should not interfere in the business consultancy area which should be left to economic agents.

b. The role of training in general and technical in particular is crucial. The recent example of the "Italy point" an agency for the promotion of management training promoted by Confindustria, Confagricoltura, together with Ifoa, and with the participation of Polytechnic University of Timisoara is a good example of cooperation between association of foreign firms and universities.

c. The quality of students of the regional universities is widely recognised but an increasing phenomenon is the emigration of local talented people (especially engineers). This problem can only really be addressed through economic development but in the short term a local scheme can be devised using the framework of European funds. The institution of the Great Cambridgeshire Partnership in 1998 could be taken as a good example of cooperation and networking between local authorities, universities and research centre, government and local firms.

d. Industrial areas have been partially realised (Arad) and already planned (Timisoara) and their accomplishment should be sped up. As the number of firms growths, the need for new spaces increases. Quick approval of needed licensees and dedicated spaces for production but also for office facilities will help the creation of new business initiatives.

e. In this context the realisation of a logistic centre could be also very important in order to increase the attractiveness of investments in the area dedicated to distribution activities.

f. Local authorities should make the maximum effort to adopt where possible e-government technique. This not only decreases costs and promote innovation, but also tends to increase clarity of rules.

6.2 Macro aspects

On the macro side the OECD (2002) recommendations and the agenda set by the European Commission for accession clearly defined the steps to be taken in order to implement a competitive market economy able to compete in the international arena. This progress, if fully achieved and consolidated, will constitute the best framework for improving the competitiveness in the entire country and in the region of Timis and Arad as well. Even so, some points have been constantly raised by Italian entrepreneurs and should be taken into consideration even for the development of local policies.

a. Even if the majority of the administrative rules and obligations come from the national level some remain local. Any improvement in the administrative set of rule in the sense of simplification and stabilisation will be welcomed. This point is extremely important for SMEs. For them the incidence of administrative costs is much higher than for large firms The more flexible structures of SMEs, these SMEs heavily rely on external consultants for most of the administrative tasks. The lack of stability of the rules not only increases administrative costs but also boosts uncertainty promoting unfair discrimination and encouraging rent-seeking activities in order to obtain discretionary measures. These are in most cases limited only to large firms which have a much higher lobbying ability compared to SMEs. Moreover, this weak and somehow confusing regulatory framework surely is a contributing factor in discouraging further foreign investors.

b. The role of physical infrastructures (mainly transportation) have been repeatedly underlined as important by firms in the area. Clearly the dimension and the scope of such facilities is well behind the possibilities of any regional authorities and sometimes even of national authorities. Regional authorities can anyhow coordinate themselves in order to develop an effective lobbying action which would clearly define priorities to national authorities and supranational entities.

c. An institutional framework is important and every institutional level should play its role. Autonomy (political and financial) at every level (from municipalities, counties, and regions up to the national and European level) should be increased together with a co-ordinated approach.

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ACCESS TO FINANCE FOR MICRO, SMALL AND MEDIUM-SIZED ENTERPRISE DEVELOPMENT IN THE TIMISOARA AREA, ROMANIA

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1. INTRODUCTION

Small enterprise development is rapidly increasing in importance in the South Eastern European (SEE) region as a whole. Romania is no exception. One of the areas in Romania that has been notably dynamic in this respect is the area in and around the city of Timisoara, hence the focus of this short paper. The paper has been commissioned specifically to be presented at the OECD/LEED Timisoara Conference on "Clusters of Enterprises and the Internationalisation of SMEs: The Case of the Romanian Region of Timisoara" on the 24th of May 2004, so as to stimulate policy debate on the dynamics, problems and potential of the area.

The focus of this paper is much narrower than the overall theme of the conference. It is specifically to highlight some of the key policy trends and issues of importance as far as finance for small enterprise development (defined as micro, small and medium-sized enterprises or MSMEs) is concerned. Clearly, the scope for developing clusters of enterprises and the prospects for innovation and internationalisation may be either supported or hindered by the extent to which firms are able to access finance.

The paper starts by providing background information on MSME trends and issues in Romania, as well as the Timisoara area, defined as Timis County of Romania. It then concentrates on the key theme, namely the key sources of MSME finance that are available and the extent to which local MSMEs gain access to formal sources of finance. The analysis suggests that although the western region of Romania, within which the Timisoara area is located, is relatively successful in obtaining access to finance (second only to the Bucharest-Ilfov region around the capital city), there remains a gap in finance as far as start-ups and established MSMEs are concerned. This gap is so significant that any other considerations, such as access to finance to support to innovative and/or international strategies, are of secondary importance to local MSMEs. The report concludes by highlighting a set of policy reforms designed to improve basic access to investment and working capital in the Timisoara area.

2. THE SMALL ENTERPRISE SECTOR

2.1 MSMEs in Romania and the Timisoara Area

Romanian MSMEs are determined according to the number of employees, turnover, and social criteria. Table 1 below compares the Romanian definition of an SME with that of the European Union.

Table 1: Romanian and EU SME Definitions

	Micro	Small	Medium
Romania			
Maximum number of employees	<10	<50	<250
Turnover	<8	<8	<8
Capitalisation	n/a	n/a	n/a
Other conditions (social capital/ the right to vote obtained by other companies)	n/a	25%	25%
European Union			
Maximum number of employees	<10	<50	<250
Maximum turnover (in million Euros)	n/a	7	40
Capitalisation (in million Euros)	n/a	5	27
Other conditions (social capital/ the right to vote obtained by other companies)	n/a	25%	25%

Source: MIMMC (2004a)

At the end of 2002, there were 804,335 registered enterprises in Romania, of which 343,000 were active MSMEs. A large proportion of dormant enterprises exists, in part because the exit barriers remain high. The birth rate of enterprises was significantly lower (7.5%) than the mortality rate (19%) in 2002, due mainly to the fact that significant efforts have been made to delete many dormant enterprises from the register (MIMMC 2004b).

As in the case of European Union countries, the vast majority of registered enterprises are micro, small and medium-sized (MSMEs) in nature. The National Agency for SMEs and Cooperatives calculates that of all the MSMEs, 89.7% are micro, 8.4% are small, 1.9% are medium-size according to Romanian definitions. 99.7% of all enterprises are MSMEs, which is very similar to the EU-19 average of 99.8% (MIMMC, 2003a).

A key indicator of enterprise dynamism is the number of SMEs per 1,000 inhabitants. The Romanian average of 10.3/1,000 inhabitants compares poorly with the average for EU-19 countries of 52.8/1,000 inhabitants (OECD-EBRD, 2003), suggesting that there is a good deal of scope for strengthening the MSME sector in Romania.

Turning specifically to the Timisoara area, defined in this paper as being the Timis County (the Counties are called “Judete” in Romania) within which the city of Timisoara is located (the 4th largest city in Romania with 700,000 inhabitants). Timis County borders Serbia and Montenegro, and Hungary, and has steadily evolved into a key gateway to Eastern Europe for investors, by virtue of its geographic location, history (was part of the Habsburg empire), infrastructure and labour market specificities.

Timis County is the most economically dynamic County in the Western region, which included three other Counties: Arad, Caras-Severin and Hunedoara. According to MIMMC (2004b), between 2001 and 2002 the greatest increase in SMEs per 1000 inhabitants took place Western region. The growth rate (13,7%) was almost twice that of the country as a whole (6,5 %). The dynamism arises partly from the fact that it represents the key industrial centre in the country and because is has been able to attract significant levels of Foreign Direct Investment (FDI), leading to major new opportunities in the area. The key branches of industrial activity include machine engineering, mechanical engineering and electronics, food industry, textiles, footwear, chemicals, petrochemicals and wood processing (CoC, 2004).

There were 29,394 active enterprises registered in the Timis Trade Register at the end of the first quarter of 2004. Out of these, 99% are MSMEs and the remainder were large enterprises. The unemployment rate was 3.9%, compared with the national average of 7.7% in March 2004. The strong industrial, engineering and research traditions, combined with more recent developments in the hi-tec, IT and communication technologies, and the relatively highly qualified labour force (there are 10 universities in the County), have been important factors in attracting FDI to the area. They also offer a strong basis for harnessing the enterprise development the potential offered by R&D and innovation (see West RDA's Innovation Strategy, 2004).

Indeed, the area's success in attracting FDI has been so great that it ranks second only to the Bucharest area and the main FDI destination in Romania. In concrete terms, it is estimated that about 19% of all the registered firms are either joint ventures or foreign owned enterprises with nominal invested capital worth $400 million. The trend continues in that about 40 foreign enterprises register locally per month. The main investors in the area as illustrated in Table 2 below.

Table 2: Volume of Investment & Number of Enterprises (2003)

FDI by Origin of Country	Number of Enterprises	Capital Invested (USD million)
Italy	1,638	70
Germany	1,284	128
Syria	308	22
Austria	266	22
Serbia and Montenegro	236	N/A

Source: Timis County Database

The main investor in terms of numbers is Italy, however, in terms of volume, Germany is much more important. Linguistic affinities have played a role in assisting both the Timis and Arad Counties to benefit from strong Italian interest. The German and Austrian investors have partly been attracted by the historical connections with the area. But the main factors include the location, cost differentials and economic strengths of the area.

The food processing sector remains significant, however, the most dynamic sector is industrial activities, as illustrated by Table 3 below.

Table 3: Main Industrial Activities in Timis County

Sector	Share in the total GDP
Automotive	11%
Food processing	42.3%
Machinery and equipment	17%
Electrical engineering and electronics	16.5%
Chemicals	7.4%
Textiles	6%

Source: OECD, 2004

The next section of the report analysis the current sources of finance available to MSMEs in the Timisoara area, prior to proceeding to an analysis of the degree of access to finance and the recommendations for policy change, at the national and Timisoara levels.

3. SOURCES OF FINANCE

This section examines the main sources of finance available in the Timis County, designed to address whether the Timisoara area suffers from a finance gap, as far as MSMEs are concerned.

3.1 Commercial Banks

Commercial banks provide the great majority of finance available to the MSME market. There is no shortage of branches of commercial banks operating in the Timis Country, however, none of the headquarters are located in the area. It is estimated that there are at least 30 branches present: ABN AMRO Bank, Alpha Bank, Banca Comerciala Carpatica, Banca Comerciala Romana, Banca Comerciala “Ion Tiriac”, Banca Comerciala West Bank, Banca Franco-Romana, Banca Nationala a Romaniei, Banc Post, Banca Romana pentru Dezvoltare - Groupe Societe Generale, Banca Romaneasca, Banca Transilvania, Casa de Economii si Consemnatiuni, City Bank, Demir Bank, Eximbank, Finansbank, Frankfurt-Bukarest Bank A.G., HVB Bank Romania, ING Barings, Miro Bank, Piraeus Bank Romania, Banca Comerciala RoBank, Reiffeisen Bank, Volksbank, etc. (CoC, 2003)

Two of the most important of these banks, as far as MSMEs are concerned are the Romanian Commercial Bank (BCR) and the MIRO Bank, otherwise known as ProCredit Bank in the SEE region. The BCR’s products may be taken as being illustrative of the products available through the traditional commercial banks. MIRO’s products are illustrative of the type of products available from banks specialising in MSME lending. A brief analysis of these two banks highlights the scope that exists for MSME to access finance (see also Perrett, 2003):

BCR is the largest commercial bank, with about 30% of the total banking assets and 286 branches throughout the 41 Counties in Romania. It is state-owned but is being restructured for privatization. The bank manages several credit lines devoted to the MSME market such as:

- An EBRD credit line (SME Finance Facility) worth € 75 million.
- The PHARE MARR fund worth € 6 million.
- The PHARE RICOP fund worth € 34 million.
- Various other PHARE funds (e.g. SAPARD) and credit for disadvantaged areas, some of which are designed to assist start-ups.

BCR’s loan portfolio to the SME enterprise sector in Romanian was about $600 million in 2003. This suggests that a considerable amount of its own funds is being used to support the enterprise sector, but BCR does not distinguish between the MSME sector and other enterprises in its lending strategy. They are not subject to special credits and conditions. All enterprises follow the same application process and may obtain such services as credit (interest rate of 23%), factoring, leasing, pre-finance for export, etc.

The bank recognises that the MSME sector may experience problems in obtaining credits, but this is thought to be because they tend to underreport their levels of profit as a means of minimising their tax burden (see OECD-EBRD, 2002 and 2003a for an analysis of the significant fiscal difficulties experience by MSMEs in Romania, such as constantly changing tax rates and incentives, frequent visits by the tax inspectorate, etc.), may be engaged in informal activities and generally have difficulties fulfilling BCR’s list of requirements:

- Loan application signed by the mandated company representatives.
- Company balance sheet, management report, profit and loss statement for the previous two years, latest Financial Results and Net Worth statements, the last month's trial balance.
- Forecast payments and collections (cash-flow) and income and expenditure budget.
- Inventory of costs to be financed by the loan (quantity, value, sales dates, etc.).
- Status of contracts for goods to be financed by the loan.
- Repayment schedule.
- Collaterals and related title deeds.
- Business plan (companies more than $1 million).
- Any other documents needed by the bank.

Source: BCR, 2004

MIRO Bank started operating in 1997, was incorporated as a commercial bank in 2002 and it is expected to be renamed the ProCredit Bank in 2005. It has nine branches and has further plans for expansion in the coming years. The paid-in capital amounts to € 13.5 million from shareholders such as EBRD, Commerzbank, DEG, IFC, FMO and Internationale Micro Investitonen. MIRO bank specialises in providing finance to micro and small enterprises, where if offers loans (working capital, purchase of equipment, real estate investment and other forms of investment), savings, and fund transfer services.

Miro Bank has granted 4,507 loans worth an average of € 4,800. It has steadily built up a clientele (7,300) and the value of outstanding loans is worth € 23 million. MIRO Bank offers three loan products:

- The "rapid credit" product provides loans up to € 2,500 for a period of up to 24 months at an interest rate of 24%. Repeat clients benefit from a reduction of 1% for each new loan taken. The commission charged is 3% of the value of the loan.
- The "business credit" product provides loans up to € 10,000 for 2 years at a maximum interest rate of 9% p.a., with a commission of 2.5%.
- The "investment credit" loan product lends up to € 300,000. It has a maturity of up to 5 years at an interest rate of 10%-16% p.a. and a commission of 2.5% of the value of the loan. The loan analysis is based on cash flow analysis rather than on collateral.

It is not possible in this short paper to provide an exhaustive analysis of what is on offer by commercial banks, but certain other banks are worth noting. Banca Romaneasca has 15 branches and focuses on the MSME market. Banca Transylvania was originally founded as a SME- focused bank, but has subsequently broadened its target market. Raiffeisen Bank operates in all 41 Counties of Romania through a network of 200 branches and agencies. It focuses on the lower and middle market tier, primarily those firms with a turnover of €1-€2 million.

3.2 Micro Finance

There are six main micro finance providers in Romania: Community Habitat Finance International (CHF), Soros Foundation, World Vision's Credit Consulting and Training for Business (CAPA Foundation), ROMCOM, Romanian American Enterprise Fund and Opportunity International. However, only CHF is very active in the Timis County and the wider western region.

CHF International operates a MSME credit programme (including a housing credit programme), which started in 1994 from an office in Timisoara and now has 15 offices covering 20 counties. The programme makes individual loans of $ 2,000-$20,000 for maturities of up to 24 months. Very small loans of $ 1,000 are made on an exceptional basis. The loans are US$-denominated and the interest rate is 16%

declining balance, plus a commission of 2%-4%. The average loan size is about US$7,000; over 50% of the loans are made for commercial activities, while 27% are for services, and 19% for production.

As of April 2004 the SME loan portfolio outstanding was US$ 4.7 million, consisting of 1,009 loans. The loan portfolio quality is good, with a portfolio at risk > 30 days ratio of 2.04% of the total portfolio outstanding. CHF also offers a short-term loan ($500-$2,500 for a maximum of 3 months, 6% commission) for clients.

3.3 Insurance and Leasing

There are more than 15 insurance companies, several of which also provide leasing: Agi Romania, Allianz-Tiriac, Ardaf, Asigest, Asirom, Astra, Aviva - Commercial Union, Generali Asigurari, Ing Barings, Omniasig, Silas 2002, Unita, Aig, Netherlanden, Inter American, etc.

Leasing is a market in expanding (Allianz-Tiriac, BCR, Asirom, etc.) but focus is mainly used for the purchase of vehicles, rather than equipment and appears to be largely restricted to medium sized enterprises at present (Perrett, 2003).

3.4 Equity

There are currently five venture capital funds operating in Romania:

- Romanian American Investment Fund.
- Romanian Post Privatization Fund.
- Romanian and Moldovan Direct Fund.
- Advent Central and Eastern Europe II.
- Oresa Ventures S.A.

None focus specifically on the Timis County / the western region; and there are currently no networks of Business Angels in Romania.

3.5 Credit Guarantee Funds

Romania has a relatively long history of establishing credit guarantee funds:

- The Romanian Credit Guarantee Fund for Private Entrepreneurs (CGFPR) is a private initiative that was created in 1993. It targets all private enterprises and is not restricted to a particular sector of activity. It provides 70% guarantees and charges an annual commission of 3% - 3.5% of the outstanding guarantee.

- The Rural Credit Guarantee Fund (RCGF) was created in 1994 and issues guarantees of up to € 1 million for private companies mainly in the agriculture and food processing sectors. It provides 70% guarantees (medium and long term loans) and 50% in the case of short term loans. Its commissions range from 2.5% - 3% of the outstanding guarantee, with some exemptions, such as for Farmers' Associations.

- The National Credit Guarantee Fund for SMEs (FNGCF) was created by the National Agency for SMEs and Cooperatives in 2002 with state funding to support the MSME sector, including start-ups in the industry, services, agriculture, construction and transportation sectors. There are strict criteria for eligibility and the € 10 million fund offers three products:

- Guarantees for established firms: maximum of € 400,000 – € 500,000; 60% - 70% credit coverage; annual premium of 1% of the outstanding loan for short term loans; and 2.5% - 3.5% for medium and long term loans.

- Guarantees for start ups: maximum of € 400,000 – € 500,000; 70% - 80% credit coverage; annual premium of 1.5% of the outstanding loan for short term loans; and 2.5% - 3.5% for medium and long term loans.

- Leasing guarantees: cover installments (maximum of three consecutive installments) for leasing contracts.

Since 1994, the FNGCF's short term loans have been suspended, pending clarification as to whether this represents anticompetitive state aid. Since no long term credit guarantees (10 years) have been issued and the short term loans have been suspended, the volume of activity was significantly reduced in 2004. Nine credit guarantee loans worth € 400,000 have been issued in the western region so far.

No mutual credit guarantee schemes exist in Romania at present.

3.5 Other funds and credits

Numerous other forms of finance exist in Romania. Examples include factoring (e.g. Romanian Commercial Bank), micro finance by various NGOs /donors, PHARE funded programmes and state funded initiatives such as those focusing on disadvantaged areas of the country. A comprehensive analysis of such funding sources is available through the National Agency for SMEs and Cooperatives (2003b). Various funds are not accessible to firms located in the Timisoara area. The main reasons for this related to sectoral prioritisation (e.g. funding for specific sectors of activity which are not found in significant numbers in Timis County) and geographical targeting of funds which exclude the area because it is considered to be relatively well developed.

4. ACCESS TO FINANCE

The Timisoara area is both dynamic and well-positioned for rapid development. However, access to finance is an essential ingredient for successful enterprise development. Firms need to invest in R&D, human capital, tangible assets, etc. in order to maintain and enhance their competitiveness. This section examines briefly the extent to which local MSMEs obtain access the finance for growth, as well as innovation and internationalisation in general terms.

According to the BEEPS (2002) analysis, MSMEs' access to finance (cost of, and access to, capital) is ranked fourth and ninth in the set of 21 potential obstacles to doing business in Romania (see OECD-EBRD, 2003b). Nevertheless, an analysis of the sources of finance used by the Romanian entrepreneurs to finance their working capital needs and new investments (see Table 4) demonstrates a heavy reliance on internal funds and loans from family and friends which is greater than in western European economies. Private commercial banks meet a modest share of financing needs (8.1% for working capital requirements and 6.4% for new investment requirements). Foreign commercial banks are currently largely irrelevant in the provision of finance to the MSME sector.

Table 4: MSMEs' Access to Finance in Romania (2002)

Source of Finance	Working Capital	New Investment
Internal funds	69.5	62.2
Private local banks	8.1	6.4
Family/friends	5.9	5.6
Supplier credit	3.5	1.3
State-Owned banks	2.6	2.0
Equity	2.3	0.9
Leasing	2.1	3.6
Other	2.0	1.2
Government	2.0	2.4
Customer credit	1.2	0.1
Money lenders	1.1	1.0
Foreign banks	1.0	1.4
Credit cards	0.7	0.8

Source: OECD-EBRD, 2003b

A positive trend is that the total volume of loans allocated to private SMEs is reportedly increasing. For example, this increased from 26.5% to 28.6% during the period 2000-2001 (Dowden, 2003, Table 3), with the lion's share going to large enterprises. However, this PHARE-funded report also illustrates that the situation varies a great deal from region to region (see Table 5 below).

Table 5: Structure of Credits Granted to MSMEs with Private Capital, by Size and Region

Regions	2001				2002
	Total SMEs	Micro	Small	Medium-sized	SMEs / 1,000 inhabitants
North-East	7.5	5.4	8.5	9.1	11
South-East	8.4	9.7	6.9	8.2	16
South-Muntenia	8.1	5.9	10.0	8.9	12
South-West Oltenia	4.6	4.2	4.4	5.2	12
West	11.1	10.9	9.1	13.1	16
North-West	9.2	6.5	12.2	9.8	17
Centre	11.0	6.9	13.6	13.7	17
Bucharest-Ilfov	40.1	50.4	35.4	32.0	31
SMEs Sector	**100.0**	**100.0**	**100.0**	**100.0**	**16**

Source: PHARE, 2003; MIMMC, 2004, Annex c

Table 5 illustrates the point that MSMEs located in the Bucharest-Ilfov region have significantly higher chances of obtaining credit than MSMEs located in any other region. The West region follows in second place, marginally ahead of the Centre region in third place. All other regions lag far behind Bucharest-Ilfov, confirming that there is a financing gap for SMEs in all regions of the country.

In order to obtain a more detailed perspective of the situation in the Timisoara area, a number of meetings were held in early May 2004 with financial institutions (such as Romanian Commercial Bank, MIRO Bank, CHF and National Fund for Credit Guarantees for SMEs), Regional Development Agency and business associations (such as the Chamber of Commerce and Industry, National Council for Romanian SMEs and the Confederation of Private Entrepreneurs of Timis County). Finally, a focus group discussion was help with eight MSMEs from the area, as well as three firms which benefited from FDI, as a means of cross-referencing the extent to which MSMEs in the Timisoara area are able to access finance.

A number of issues are worth highlighting from the discussion with entrepreneurs:

- None of the eight Romanian enterprises were able to obtain any form of funding at the start-up stage. All relied on internal sources, as well as family and friends. This situation is by no means unusual in that commercial banks do not generally provide support to start-up enterprises.

- All start-up entrepreneurs had tried to access finance from commercial banks, guarantee funds, etc. but had given up with the conviction that there was literally nothing available for them in the region. They are highly critical of this situation.

- The main constraints to accessing formal sources of finance are perceived to include: excessive reliance on collateral by commercial banks, high collateral requirements (150% - 200%), high interest rates, high commission charges, excessive bureaucracy (lengthy and complex application process), inflexibility (e.g. one loan at a time), short maturity of loans, etc.

- Only two of the four established enterprises had been able to access formal sources of finance (loans and leasing). These are both well established, were formed 6-8 years previously, are medium sized and have access to collateral. The other two established enterprises are not in such a favourable position and continue to experience liquidity problems and restrictions in growth due to the lack of working and investment capital.

- In all cases, entrepreneurs were highly critical of the commercial banks as well as the Romanian Central Bank. There was a perception that banks continue to prioritise other sectors of activity such as retail banking over enterprise finance. The Romanian Central Bank is considered to exacerbate the problems experienced by the MSME sector by virtue of its excessively restrictive regulations, which are deemed to impact negatively on the development of the MSME sector.

- The entrepreneurs note an increasing level of competition in the commercial banking sector. They also recognise that the interest rates are gradually being reduced, however, consider that more fundamental changes are required before they can access finance from formal sources.

- Entrepreneurs are looking for the following basic conditions, if they are to access credit from commercial banks:

  - Reduction in interest rates.
  - Longer grace period.
  - Long term funding (10 years).
  - Reduction in commissions.

- They perceive the situation to be so grave in terms of accessing any form of finance, that none of the entrepreneurs had devoted much time developing their strategies for innovation. They were not aware of any options being offered by banking and non-banking institutions to assist with this aspect of their activities (such as EU programme, state programme, etc.).

- As far as finance for internationalisation is concerned, the same issues apply as in the case of innovation. There was general agreement that the best chance of obtaining finance for growth was through joint ventures with foreign investors, thus bypassing completely the formal financial system in the Timisoara area. Although all entrepreneurs were willing to consider this option, they felt limited by the fact that half were start-ups and, therefore, not established and attractive propositions for FDI. On the other hand, the established enterprises were not aware of how they could identify and engage with potential partners from abroad.

- The overall conclusion is that there was little finance on offer for the vast majority of MSMEs in the Timisoara area, despite the fact that it is one of the most dynamic and fast growing regions of Romania. This is hindering the growth and employment potential of the MSMEs in the area.

5. RECOMMENDATIONS

In order to encourage the development of the MSME sector, the Government of Romania created a National Agency for SMEs and Cooperatives in 2002 to achieve various objectives in relation to MSME development, including improving access to financing for MSMEs such as the provision of grants to fund necessary start-up and/or expansion costs, the establishment of loan guarantee funds to facilitate access to credit, etc. The problem of inadequate access to finance is explicitly recognised by the National Agency for SMEs and Cooperatives (2004):

"Although in recent years the Romanian banking sector has been transformed, entrepreneurs and SMEs still have difficulties accessing finance on acceptable terms. Credit is available but the credit technologies used by the banking sector work against SMEs – long-term loans or cash-flow support are rarely available. The banks impose debt-to-equity ratios that are virtually impossible for SMEs to meet because of their thin capitalisation and lack of collateral. Micro and small enterprises are unlikely to grow and entrepreneurs will be unable to enter the market with innovative ideas and products unless actions are taken to improve access to finance."

The above statement points the way in terms of what might be done to improve access to finance in Romania generally and the Timisoara area specifically. According to a recent OECD-EBRD report on SMEs in the SEE region, the most effective method of providing finance for SMEs is to create dedicated channels for this activity: MSME credit lines, micro finance banks, micro credit by NGOs, etc.

Public policy initiatives to improve access to finance are mainly driven by the National Agency for SMEs and Cooperatives. Perhaps its greatest impact in this area has been its involvement in the establishment of the National Guarantee Credit Fund for SMEs. It is expected that it will increase both the number of branches (from 12 to 17) and the capital available to the fund. The National Agency for SMEs and Cooperatives has also been active in other respects:

- It organises the annual "Financing Fair for SMEs" with PHARE support.
- It organises quarterly, Round Table discussions with bankers with a view to streamlining SMEs' access to finance.
- It organises the annual "Fair for SMEs" to promote services such as consultancy and finance.
- It organises country-wide events on the impact of enlargement on the MSMEs sector and discussions on access to finance for MSMEs.
- It has organised, jointly with CHF, a draft law on micro-financing for MSMEs.

During the period 2004-2008 the National Agency for SMEs and Cooperatives plans to emphasise its activities and programmes in relation to access to finance. In particular, greater focus will be placed on the improving access to equity finance (fiscal incentives, awareness raising and establishment of an Equity Guarantee facility); developing the network of SME Guarantee Funds, including a greater focus on start-ups and a related interest rebate scheme (MIMMC, 2004).

It is clear that greater levels of bank intermediation in Romania are only likely to arise as a result of the following elements at the national level:

- Maintenance of stable micro-economic conditions, allowing interest rates to come down over time.
- Improvement of the legislation, supervisory rules and regulations of bank and non-bank funding sources.
- Reduction in limitations on micro finance operations (e.g. the draft Micro Finance Law).
- Diversification of finance options: leasing, factoring, supplier/customer credit, mutual guarantee schemes and possibly venture capital / business angels.
- Evaluation of current state funding programmes to determine whether reform is required to improve effectiveness, thus maximising impact of limited funds.

Timisoara Recommendations

Improve information and access to financing sources

Both start-ups and established MSMEs are not aware of the full range of sources of finance available (credit lines, grants, leasing, factoring, etc.), as well as the detailed terms and conditions on offer. This is a constantly changing situation, which requires updating at least every six months, followed by wide dissemination. This is a fundamental starting point for enhancing access to finance for MSMEs.

Certain organisations undertake this exercise with various degree of completeness, such as the Chamber of Commerce, Confederation of Private Entrepreneurs of Timis County, commercial banks, etc. however, this is not reaching the full range of potential and actual entrepreneurs in the region. Such a task is typically the responsibility of Business Support Centres designed to focus on start-ups and early growth enterprises, a target group that often suffers from market failure. In the absence of such an organisation, the various key players need to coordinate their activities and contribute to the creation of a regularly updated (quarterly) Compendium of MSME Finance for the Timisoara area. The information should be distributed to all members of the various business associations, as well as more widely through the Internet.

Implement a Business Support Centre

As previously highlighted, the Timisoara area lacks a Business Support Centre (BSC) to provide customised services to start-ups and early growth enterprises, including assisting them to access finance opportunities. Although the Chamber of Commerce of Timisoara has a business centre (and manages a Euro Information Correspondence Centre), this institution is focused primarily on its members as well as firms willing and able to pay commercial rates for the business advice and support. It is widely recognised that potential and actual start-ups, as well as early growth enterprises are not able or willing to use such commercial services. Consideration should, therefore, be given to the possibility of creating a business oriented BSC on a commercial and sustainable basis using the Market Development Approach increasingly supported by the international donor community (Blue Book, 2001).

Diversify the Sources of Finance by Developing Mutual Credit Guarantee Schemes

Mutual Guarantee Associations (MGA) have been recommended by the OECD-EBRD (2002, 2003b) for Romania and are acknowledged as a mechanism which offers potential for enhancing access to finance by the National Agency for SMEs and Cooperatives (2003a and 2004). The National Agency for SMEs and Cooperatives plans to explore the legal framework for the development of MGAs, however, no MGAs have been implemented in the country so far.

MGAs are private societies formed by potential borrowers who have limited access to formal credit due to insufficient collateral. MGAs assess their members, decide whether to recommend them to the lender, provide guarantees and manage defaulting borrowers. The guarantee is backed by the MGAs' capital, which in turn is based on the share capital provided by all members. Thus each member accepts a certain share of the risk associated with the guarantee, including the borrower. Since not all members require loans at the same time and few borrowers default, the members' contributions can result in a major leverage effect. The active involvement of the borrowers themselves leads to better performance than public guarantee funds and can significantly reduce asymmetric information, achieve great additionality and reduce transaction costs (see UNIDO, 2003).

Business Associations with varying levels of membership exist in the region. The Timisoara area is, therefore, well placed to take advantage of such a mechanism and should seek to develop pilot initiatives based on state, donor and related funding. The European Mutual Guarantee Association has been actively encouraging the spread of MGAs in the CEE and SEE regions and should be involved in this process.

Diversify the Sources of Finance by Increasing Take-up of Leasing

A key constraint in the area is the perception of excessive reliance on collateral for gaining finance. This applies in all regions, but is generally more pronounced in areas where there are bank branches, rather than the headquarters. The branch staff may not have as much flexibility and capacity to understand business plans and rely more heavily on collateral to insure against the risk of lending. Leasing uses an alternative methodology which does not emphasise collateral and may thus increase the prospects of MSMEs obtaining finance. This is a rapidly growing source of finance in Romania and there is a need to raise awareness of the pros and cons of using such funds and that is not restricted to vehicles.

Increase Access to NGO / State Finance

It is widely recognised that certain types of clients are non-bankable: start-ups and enterprises in rural areas which are often devoid of bank branches (see OECD-EBRD, 2003a). The activities of NGO are very important in making finance available to these non-bankable clients, however, there are relatively few of these institutions in the Timisoara area. The fact that the area is relatively dynamic and has attracted a large proportion of FDI, weighs against the development of more such initiatives. However, the agricultural sector is almost as significant as the industrial sector in the Western region, allowing scope for the Regional Development Agency and other players to lobby for greater access to funds for start-ups and rural development. The PHARE / ISPA / SAPARD programmes and, in due course, EU Structural Funds should be targeted for such funding, as well as donors and NGOs.

Finance for Innovation and Internationalisation

None of the firms in the focus group had gone as far as developing strategies for innovation and internationalisation. Most were so focused on obtaining adequate access to working capital and investment finance for their every day working needs that these issues were relegated in importance. Whilst the commonly accepted wisdom is that entrepreneurs in the SEE region are less willing to consider options such as venture capital and joint ventures due to concerns about possible loss of control over the management of the firm, the entrepreneurs participating in the focus group discussion considered joint ventures as the only realistic source of growth finance that might be available to them. The Timisoara area may be unusual in this respect, possibly reflecting the fact that almost 20% of the local enterprises include some form of foreign participation.

Given this willingness to engage with international enterprises, there may be advantages in seeking to provide practical business matching services, enabling firms with common interests to meet and make business decisions, such as the creation of joint ventures. This process is currently taking place in an ad hoc manner and requires more support and coordination, possibly by the Regional Development Agency or proposed Business Support Centre.

Establish a Business Angel Network

Related to the point above, given the level of investor interest in the region, it may be sensible to develop a Business Angel Network in the region. Business Angel Networks can provide SMEs with access to prospective investors who may provide finance for such developments as start ups, expansion and transfer of ownership (see CED, 2001).

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