Eurasia Group Global Trends Quarterly

Evolving Outlook for Businesses in Central and Eastern Europe

Executive summary

In the aftermath of the global financial crisis and amid the sovereign debt crisis afflicting a number of EU countries, companies doing business in central and eastern Europe (CEE) can find rewarding opportunities. Economic growth in the region, although uneven from country to country, has rebounded strongly from the global downturn on the heels of fiscal reform. CEE economies are among the most open in Europe, and the region still offers highly competitive wage rates relative to other EU countries. Favorable tax regimes, improving infrastructure, and efficient supply chains have also improved the investment environment. Nonetheless, some important risks for businesses remain. In particular, the delayed timeline for euro adoption due to the EU sovereign debt crisis removes a critical incentive for structural reforms across CEE. As a result, austerity programs in countries such as Poland and Hungary have had setbacks. In addition, growth in CEE is to a certain extent dependent on a broader euro-area recovery. Uncertainty about some of the single currency's weaker economies, including Greece, Ireland, and Portugal, combined with conservative outlooks for some of the larger western European economies, could slow the pace of growth in CEE. As such, and in light of the positive growth story in Germany, improving CEE-German economic ties, particularly trade and supply chain integration, will be an important driver of CEE growth and business opportunities.

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Overview

Central and eastern Europe's (CEE) political and economic integration with western Europe over the past two decades has been impressive and transformative. On the economic front, cross-border trade and investment have been consistently strong, and the economies of east and west are interconnected to an extent that seemed improbable at the start of the transition from communism. Political institutions have developed along lines that mirror the West, including stable parliamentary democracies and increasingly professional and effective bureaucracies.

CEE is also recovering rapidly from the global economic crisis. Although some countries (for example, Latvia and Romania) were severely affected by the downturn, the prospects for economic growth have picked up across the region. Annual estimates for GDP growth in the medium term range from 3.5%–4% in Poland and Estonia to 0%–3% in the Czech Republic, Hungary, Bulgaria, and Slovenia. This development is largely due to governments' commitment to difficult structural reforms.

Still, some risks remain. Growth in CEE is to some extent dependent on a euro-area recovery, given that CEE countries typically feature small and medium-sized open economies that rely on intra-EU trade and investment. And while the German growth story is currently positive, uncertainty about some of the single currency's weaker economies, including Greece, Ireland, and Portugal, combined with conservative outlooks (partly due to the effects of austerity measures) for some of the larger western European economies could offset this momentum somewhat.

The lack of progress on austerity in some CEE countries is also a potential liability. Poland and Hungary will face particular challenges in this regard. Hungary has already attempted to assuage frustration with austerity measures through populist policies that target the private sector, including the nationalization of private pension funds and the imposition of punitive taxes on multinational companies. This could set an unhelpful precedent as other countries in the region look to balance EU- (and in some instances, IMF-) mandated deficit reduction targets against short-term political pressure at home.

While much of the mainstream debate regarding the EU's sovereign debt crisis has focused on western Europe—especially the relationship between the core (creditor) and peripheral (debtor) countries—less attention has been paid to the implications for CEE. This is in spite of the important political and policy shifts that the crisis has produced across the region, particularly regarding the timing of euro adoption. Delayed adoption carries important consequences for the region's reform outlook in the near and medium term.

The CEE business environment

Wage rates	Competitive
Trade policies	Generally open
Political environment	Generally stable
Tax regimes	Business-friendly
Infrastructure	Improving
Trade relations with Germany	Expanding
Cross-border supply chain integration	Growing
Euro adoption prospects	Delayed
Pace of economic reform	Slowing

Analysis

CEE continues to be an attractive business destination

CEE economies offer many advantages for foreign investors. The economies are among the most open in Europe, and their unit labor costs are among the most competitive (having dropped by 5% in the past ten years, while costs elsewhere on the continent have generally remained stagnant). Other comparative advantages include competitively skilled workers, favorable tax regimes, relatively stable political and financial environments, improving physical infrastructure, and efficient logistics and supply chains. Economic systems in CEE are based on private ownership and competitive markets—important components of EU integration.

In Poland, for example, a number of reforms targeting the product market have been in play over the last decade, with the aim of reducing business costs and improving the country's investment climate. Reforms have ranged from facilitating property registration to easing credit access and enforcing contracts. As a result, the capital city of Warsaw has attracted a large number of foreign companies and skilled workers, as have regional centers such as Gdansk, Poznan, Wroclaw, and Cracow.

In addition, CEE governments have allocated their own, as well as EU, funds to improve transport infrastructure and thereby prop up local industries. As CEE countries invest more in R&D to complement the stream of FDI flowing into manufacturing, newly acquired skills and know-how may facilitate a gradual move up the value chain. Countries in CEE are also emerging from the global economic crisis with relatively healthy public finances, boosting their economic outlook. The region is therefore poised to benefit from foreign investment in the medium term. That trend will likely be reinforced as CEE economies gain from EU integration and become even more attractive for investment, particularly from Germany.

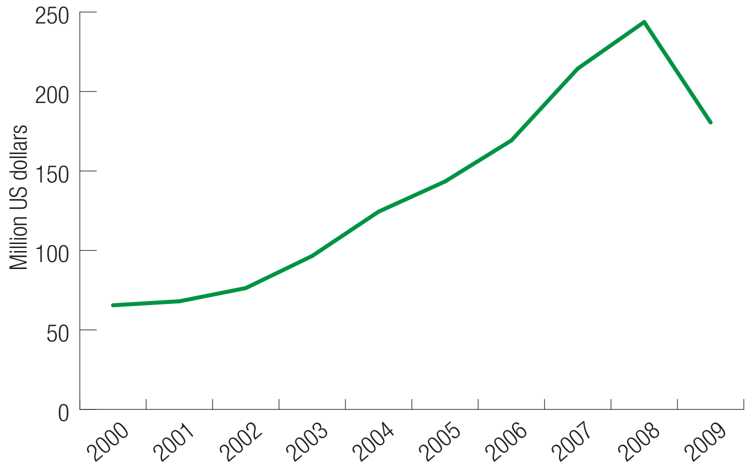
Furthermore, for much of CEE, migration to the UK has been a net positive development. It has lowered unemployment, led to substantial remittance flows, and, in many cases, provided excellent training and language-development opportunities for the migrants. And companies in CEE can fill left-behind low-skilled positions with migrants from other parts of the former Soviet Union/central Asian region, meaning that no real skills gap has emerged—especially since migrants tend to return east after a number of years. While there were reverse flows from the UK and Ireland to Poland and Slovakia during the global economic crisis, those have recently abated and there are indications that the migrants have since returned to the UK and Ireland.

EU sovereign debt crisis delays timetable for euro adoption

The prospect of EU entry provided a strong incentive for reform across CEE. When the ten countries (Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Cyprus, and Malta) joined the EU in 2004, followed by Romania and Bulgaria in 2007, they had already completed a decade of political and economic reform. That process was prompted by their adoption of the Acquis Communitaire—15 chapters of EU law that ensure compliance with the EU's "Copenhagen Criteria" on democracy, the market economy, and human rights. Since their admittance to the union, however (upon which EU negotiators lost most of their leverage), the momentum behind domestic reform has slowed. This explains why the French and Germans have been reluctant to admit Romania and Bulgaria into the Schengen zone of visa-free travel; entry is seen as the only near-term incentive that will encourage the two countries to implement reforms regarding corruption and the judicial process.

Yet while the Schengen zone is important, only euro adoption and membership in the euro-group (the political decision-making committee of eurozone countries) has the potential to propel and sustain movement on major structural reforms akin to those undertaken by countries that aspire to EU membership. And the timetable for euro adoption has slipped across the region as a result of the sovereign debt crisis—even though in principle it is a legal obligation for the CEE countries that joined the EU in 2004 and 2007. (Only Slovenia, Slovakia, Estonia, Cyprus, and Malta have adopted the euro so far.) As such, the most powerful EU incentive capable of sparking near-term structural change in CEE has arguably been lost. This is true despite the fact that CEE countries have traditionally been very keen to adopt the euro. CEE has had relatively unhappy experiences with freely floating exchange rates, and expanding intra-industry trade with western Europe—especially Germany (see more below)—has cre-

Total trade between CEE and Germany



Source: IMF Direction of Trade Statistics

ated an important constituency of exporters who stand to gain from the elimination of exchange rate uncertainty.

In the larger CEE countries, adoption has been pushed back significantly. Poland's governing coalition of the Civic Democrat Party (PO) and Polish Peasant Party (PSL) last year dropped its 2012 target date and has yet to announce a new one (although 2015 has been floated unofficially). In Hungary, Fidesz's populist prime minister, Viktor Orban, has stated that euro entry will likely not be realistic until the end of the decade. The three-party Czech coalition has yet to announce a new entry date since the original (2010) was jettisoned by a previous administration, while President Vaclav Klaus—one of the most skeptical leaders in the EU—has questioned whether the government's legal obligation to join is still valid given the eurozone's predicament. Finally, Romania's 2015 entry date remains more aspirational than real. While these countries will remain attractive investment destinations compared with many of their western European counterparts, the momentum behind reform is unlikely to be as dynamic as it would have been were euro adoption a near-term objective.

Germany will be a critical driver of growth in CEE

Economic ties between CEE countries and Germany have improved over the past few years and will become increasingly important in the medium term. For Slovakia and the Czech Republic, the relationship blossomed after they joined the EU in 2004 and gained access to the lucrative German market. And Germany—a stalwart of European industrial growth—developed an efficient economic model based on export-led growth that has benefited by outsourcing production to its eastern neighbors.

As they have developed their competitive assets—lower labor costs, favorable tax environments, and educated workforces—the Czech Republic, Poland, and Slovakia, among others, have also deepened their economies' integration with German supply chains, and their manufacturing sectors have become important sources of growth. CEE-based manufacturing accounts for about 18% of the intermediate goods that feed into the German supply chain. In France, where state aid is directed to firms that keep manufacturing jobs at home, this figure is only 5%. Germany's trade surplus has grown as the country has diversified its production to CEE and exported to both Europe and to expanding markets in Asia. Germany will likely keep refining this successful model and continue expanding its production base in CEE.

Germany has also become the region's most important trade partner. By specializing in the production of intermediate and capital goods, CEE countries develop broad networks of suppliers and component manufacturers to service their own and German demand. Again, this trend would have been even more pronounced were CEE countries hoping to adopt the euro in the near term (as fixed exchange rates would eliminate some uncertainty and lead to greater bilateral CEE-Germany trade and investment flows). But another opportunity for German-CEE integration will come when Germany opens up its labor markets to CEE countries on 1 May. Workers from CEE will find employment in Germany, easing labor shortages there. This will likewise be an opportunity for knowledge transfers, especially as CEE workers return home with expanded skill sets.

Business implications

- **Strong growth in Germany will buffer CEE countries from lower growth in the rest of the EU:** The growth outlook across much of the EU (especially in the eurozone's periphery) will likely be below trend for the foreseeable future. The impact on CEE should be limited, however, given Germany's strong economic performance and the growing bilateral trade and investment flows between Germany and CEE countries.

- **Despite the slipped timetable for euro adoption, CEE economies offer distinct advantages for foreign businesses:** CEE economies are among the most open in Europe (as measured by trade as a share of GDP) and most productive (in terms of their unit labor costs). Moreover, their macroeconomic and regulatory environments (including favorable tax regimes, opening financial markets, and upgrading physical infrastructure) continue to improve as more economic development funds flow in from the EU.

- **Cross-border supply chains will expand trade in services:** Businesses are increasingly comfortable with having their supply chains based in multiple parts of the EU. As firms locate more operations in CEE to take advantage of the region's low-cost environment, and as governments push to liberalize the services sector, another important source of growth could open up in the medium term.

- **Fiscal incentives and industry/consumer clustering will boost the attractiveness of second- and third-tier CEE cities:** Regional governments are trying to entice businesses from Germany and elsewhere to relocate to second- and third-tier CEE cities with fiscal incentives. Firms will enjoy lower taxes and wages in these cities, and the clustering of industry and consumer spending there will enable them to capture income growth. To some extent, this clustering has already taken place—around the auto industry, for example, as well as the back-office service-logistics sector in the Czech Republic, Slovakia, Poland, and Hungary, where governments have created more liberal tax and regulatory regimes to attract investment. Another example is the market for flat-screen televisions: A number of large competitor companies share production facilities in Wroclaw, Poland.

- **Businesses have clearer lobbying channels:** Because the EU policymaking process is more rational and coherent than those that take place in individual CEE countries, businesses based in CEE now have clear avenues through which to influence legislation. Large networks of lobbyists have sprung up to help businesses in CEE identify contacts within the Brussels-based institutions (the European Commission, the European Council, and the European Parliament) in order to express opinions on legislative proposals in play.

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