FROM SMART *FOLLOWERSHIP* TO BOLD *LEADERSHIP*

THE ECONOMIC FUTURE OF CENTRAL AND EASTERN EUROPE

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Extract

Central and Eastern Europe successfully leveraged for three decades its favorable mix of cost advantages and technical skills. However, with a declining and more expensive workforce, with many jobs impacted by the greening and digitalization trends, the region must find new sources of competitive advantage. Many regional champions are already charting a new path.

For the most part, the transition economies of Central and Eastern Europe (CEE) and the former Soviet Union have seen impressive growth and broad economic progress[2] in the three decades following the fall of the Berlin Wall[3].

Poland's GDP per capita has grown nine-fold, and Poland was one of only three countries in the world, with China and Australia, to avoid a recession from 1992 to 2019[4]. The Prague region has become the 6th richest per capita in the EU, well ahead of Stockholm or Stuttgart[5]. The French establishment had to learn how to pronounce the name of the surprise Czech investor in the daily "*Le Monde*", Daniel Křetínský[6], the majority owner of the energy holding EPH[7] - Europe's 7th largest producer of electric power, and an active investor in Europe's retail sector. Slovakia, starting practically from scratch in 1991, turned itself into the world's biggest car producer per capita[8].

During the first three decades of transition, recipes for economic success leveraged the region's favorable mix of cost advantages and technical skills. However, with a declining and more expensive workforce, with many jobs impacted by the greening and digitalization trends, the region is at a defining moment. If it is to avoid being stuck in the elusive "middle-income trap", it will have to find new sources of competitive advantage. Smart followership will need to be replaced by bold leadership.

Biggest achievement: integration in global value chains

Integration in global **industrial value chains**[9], such as the automotive one[10], has been the best-known, and arguably the most successful, strategy for success. Competition from Asian and US automakers forced German, French and Italian producers to look for cost improvements. That proved to be a great opportunity for countries close to Europe's industrial heartland. The auto industry represents 44% of Slovakia's industrial production and 40% of its industrial exports, levels also found in Czechia and Hungary. While auto's share is smaller in the Polish, Romanian and Slovene economies, this industry has created entire clusters and rekindled industrial activity through spillover impacts on domestic supply chains. Similar value chain integrations have happened in chemicals, industrial equipment, and textiles. And, over time, as investors minimized costs, countries located "further East", such as Bulgaria or Ukraine, have also benefitted.

More recently, integration in **service value chains** has played an increasingly important role in economic development. Many attractive jobs have come from IT and business services outsourcing. Eleven countries in the region were among the top thirty-five global outsourcing destinations in the 2019 Kearney Global Services Location Index[11], and fifteen cities are on Tholons's 2020 list of 100 "Super Cities" for outsourcing[12]. There are over a million IT developers in the region and IT and business services outsourcing has transformed cities such as Kraków in Poland or Sibiu in Romania. In the global financial services industry, a growing share of mid and back-office operations is located in cities such as Riga in Latvia or Budapest in Hungary.

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Some countries have been significantly more successful than others. For instance, Romania and Ukraine had the same GDP per capita in 1990[13], whereas by 2019 Romanians were on average almost four times richer[14] than Ukrainians. Geographical proximity to Europe's economic North-South core, stretching from Manchester to Milan[15], was a big factor, as was full membership of the EU[16], bringing access to the single market, cohesion funds and the new NextGenerationEU economic recovery and resilience mechanism[17]. Finally, and not surprisingly, countries that developed good institutions, implemented fair regulation, and fought corruption did significantly better[18].

Major risk: getting stuck in a "middle-income trap"

However, even before Covid-19 struck, policy makers and businesspeople from the region started to realize that integration in global value chains both increased vulnerability to external shocks[19], and also created a serious risk – that of getting stuck in a "middle-income trap"[20], or a form of "post-industrial stagnation".

This is, above all, because the biggest strength of the region - its qualified and cost competitive **labor force – is shrinking and becoming more expensive**. Indeed, almost all post-communist countries have a faltering demography[21]. Low fertility rates combined with growing emigration have had a deep effect. With EU enlargements, short and long-term migration has grown rapidly[22]. Between 4 and 10% of the CEE member states' population moved West over the past 15 years, with the exceptions of Czechia, Slovakia and Slovenia. Working populations have shrunk by 10% over the past five years in the Baltics, and medical personnel is becoming critically scarce in the Balkans[23]. In order to deal with this issue, Poland became in 2017 the OECD country with the highest inflow of temporary labor migrants[24], some 1.1 million officially, mainly from Ukraine. But Poland has been so far an exception, as other countries do not offer the same opportunities and will simply have to build a future with a smaller working population.

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On the positive side, remittances have soared, reaching a historic high of $65bn in 2019[25]. Ukraine was the top recipient in absolute terms with $16bn, more than double from a decade ago. In some countries, remittances have become an essential financing flow, reaching 29% of GDP in Kyrgyzstan and Tajikistan, followed by Moldova (16%), Bosnia & Herzegovina (10%) and Albania (9%) in 2019. This labor movement might have been unavoidable, and it has created a transmission channel for capital and technologies benefitting business back home. But there is no fitting compensation for the missing skilled workers and the brain drain.

With tensions on the labor market, **wage bargaining power is rapidly changing sides**. Productivity and wage growth have generally risen hand in hand in the region[26], but starting around 2016 policy decisions, negotiations and strikes, broke that productivity-wage link. In just four years, nominal minimum wages had increased by 39% on average in CEE countries, three times faster than in the "old UE", and significantly ahead of productivity improvements. Minimum wages doubled in Romania and increased by 73% in Lithuania and 45% in Bulgaria[27]. The trend has continued in 2020, notwithstanding Covid-19, and the proposed Minimum Wage Directive will only push for further convergence of labor costs across the EU[28].

Furthermore, the most successful industries of the region happen to be also those most **impacted by the "twin" digitalization and greening trends**. The automotive industry is undergoing an unprecedented upheaval because of the shift towards electric cars and digital technologies[29]. Many of the traditional outsourcing jobs in the region are at risk from robotization and artificial intelligence[30]. Carbon-intensive energy and industries are under intense pressure. Stunningly, the EIB assesses that 55% of CEE EU regions are exposed to high risk of job losses due to the "twin" trends, compared with 23% in Southern Europe and 15% in Northern and Western Europe[31].

As EU and US private FDI to the region decline[32], traditional approaches are yielding diminishing returns[33]. In addition, with the convergence of income levels across the continent, EU's financial support will also drop significantly post-2027. Some in the region saw trade tensions between the US, China and the EU, as well as Covid-19 supply-chain effects as a source of "near-shoring" opportunities, but those are taking time to materialize[34]. On the contrary, with the impact of wage increases and Covid-19, three companies (Johnson Controls, AT&T and IBM) recently announced firing hundreds of people in Slovakia[35] and moving to cheaper locations, such as India.

Moving toward a green and digital future: from smart follower to bold leader

Where are the new sources of competitive advantage and the new jobs to be found? Clearly, a new economic model is needed[36], one that goes beyond competing with neighbors to do what the West is neither willing, nor able to do. Smart followership will need to be complemented by innovation. Transition needs to be replaced by bold leadership.

In **traditional sectors**, this means **achieving a scale or cost advantage** that could secure a sustainable European or global position. There are already several successful examples of this strategy across the region:

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Ukraine's poultry giant, MHP[37] has been implementing a worldwide expansion plan for over a decade. It acquired Slovenia's Perutnina and is one of the European leaders. Kernel[38] has become in just 25 years the world's leading sunflower oil producer and Ukraine's largest grain exporter. Hungary's Gedeon Richter has one of the widest Women's Healthcare portfolio worldwide. After acquisitions in the US, Germany and in Latin America, 90% of its €1.5bn sales are international. The Czech LINET, created in 1990, is among the top four global hospital bed manufacturers, exporting to more than 100 countries. WizzAir[39], the Hungarian, US Indigo Partners-backed, *ultra-low cost* air carrier was established in 2003 to fly Easterners to their new jobs in the West. It ranked 8th in Europe in 2019 by passenger numbers, but its market capitalization is now larger than EasyJet's and more than double Air France-KLM's. Lithuania's Girteka[40] has become Europe's leading freight company, with some 7,500 trucks, taking over some of its Western competitors.

In **services**, Czechia's KKCG Group's subsidiary Sazka[41] has built the only pan-European lottery operator, with leading market positions in Czechia, Greece, Cyprus, Austria, and Italy. It has just gotten a €500 million capital injection from America's Apollo private equity fund to expand. Hungary's leading bank, OTP,[42] has bought out Western competitors leaving the region, creating a strong network in eleven countries, with a current market capitalization of around €10bn, almost double that of former CEE Austrian leader Raiffeisen. Czechia's PPF has created a global consumer loan provider, Home Credit. It is the largest non-domestic player in China.

In **energy**, past success came, particularly in the former Soviet Union, from intensive exploitation of fossil energy sources. Oil production almost doubled between 2000 and 2019, while the production of gas increased by 30%. At about the same time, a long cycle of price increases started, with oil and gas prices quadrupling by 2013[43]. Although prices have since retreated, they remain in nominal USD terms more than double those of twenty years ago. This has brought huge resources to Russia, Kazakhstan and Azerbaijan but has also increased the risk of a "natural resource curse".

That energy cycle has come to an end. The green energy transition has led Western companies to try to move out of coal and increase the share of renewables as rapidly as possible. Companies from CEE have tried to be **more tactical, combining for the next three decades fossil sources with renewables** so as to simultaneously play two time-horizons: during the transition, when fossil sources will still be needed to stabilize energy systems, and post transition[44]. Czechia has generated a number of such tactical industry shapers. EPH has acquired, in a series of transactions worth several billion euros, fossil-based and renewable assets in Germany, France, the UK, Ireland, and the US. Other Czechs, such as Seve.en Energy[45], or Energo Pro[46] are no less aggressive, across the globe. In Poland and Hungary, national energy champions are created under the auspices of their governments around PKN Orlen[47], PGE[48] and MVM[49] in order to compete on the European scene. But the real opportunities are arguably in the **pan European green energy projects**. Poland is one of the seven founding EU countries backing the new European battery value chain for electric vehicles, which brings with it a total of €1.75bn in approved state aid[50]. In turn, it already received Korea's LG Chem (€1bn), Belgium's Umicore (€125m), and UK's Johnson Matthey's (€135m) battery-related investments[51]. Hungary just got a €2bn commitment from Korea's SK to build Europe's largest battery factory of 30 GWh [52].

In **technology**, the new model requires **leveraging traditional strengths in science and technology to build European leaders and start-up unicorns**. Tech entrepreneurs from the region have helped launch many tech giants across the world. Now, though, with more readily available financing in Europe[53], many entrepreneurs are choosing to stay closer to home and are creating their own champions[54]. In e-commerce, Poland's version of Amazon, Permira/Cinven/ MEP-backed Allegro[55], created a global stir when its October 2020 floatation on the Warsaw Stock Exchange produced a market capitalization of around €15bn, giving it a better relative valuation than its famous US competitor. In January 2021, having benefited from Allegro's rise, the Advent-backed Polish locker company InPost itself listed at a €8bn value, an industry record. Two months later it acquired the French out-of-home parcel delivery platform Mondial Relay, for €565m in cash. Romania's Prosus-backed eMag[56] is Southeast Europe's undisputed e-commerce leader, with

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top spots in Romania, Hungary and Bulgaria. Serbia's BC Partners-backed United Group is the cable and media leader in ex-Yugoslavia, Bulgaria and Greece[57]. The region is excelling in cybersecurity: Czechia's Avast[58] has a c.€6bn market capitalization, as part of London's Footsie100 index, and it purchased its Dutch competitor AVG for $1.3bn in 2016. Slovakia's Eset[59] and Romania's Bitdefender[60] are among the world's best endpoint cybersecurity companies[61]. The region has also generated some of the world's largest software development companies. EPAM has Belarusian origins, deep CEE roots and is listed in the US with a $20bn market capitalization. Luxoft, with Russian origins, was acquired in 2019 by America' DXC Technology for $2bn. In IT systems development, Poland's Asseco[62] is already Europe's 6th largest, listed in Warsaw and Tel Aviv at a $1.3bn valuation. The Baltic Republics, with its engaged regulators, have staked a strong claim in fintech, in particularly in digital payments and e-money, and can claim big successes such as Wise[63] or Revolut[64]. Romania's UiPath[65] is the world's leading robotic process automation firm, and the latest $750m funding round valued it at a staggering $35bn. Infobip[66], Croatia's first unicorn, is one of the leading "communication platform as a service" companies, and received one of the largest European software Series A rounds ever from One Equity Partners. Docplanner[67], the Polish medical booking platform is going for global leadership and is the top choice in Latin America. Gaming is also very popular, with leaders such as Serbia's Nordeus[68], Slovakia's Pixel Federation[69] and Poland's CD Projekt[70] and Huuge[71]. Finally, two of the top ten European cross-border marketplaces are CEE-based, Vinted[72] of Lithuania for secondhand clothing or G2A[73] of Poland for gaming[74].

In aggregate, the share of ICT in the GDP of seven of the eleven CEE EU members is already above EU's average[75.] According to ECERP's Geography of Europe's Brain Business Jobs: 2020 Index[76], parts of CEE have witnessed the fastest growth of "smart jobs" (tech, ICT, advanced services and creative professions) of the continent, with Hungary, Latvia, Czechia and Slovenia overtaking in six years France, Belgium and Austria in "smart jobs concentration". The Bratislava region has Europe's strongest concentration, with 19 percent of the working age population employed in knowledge-intensive businesses, ahead of Oxford and Stockholm.

As a testimony of this newfound confidence, many CEE companies now expand abroad through acquisitions[77]. Over the past six years, CEE companies have acquired some 470 companies in the region for a total of c.€20bn in disclosed value, and, even more remarkably, some 270 companies in the West, for a reported c.€20bn in total value. Total transaction values are higher in reality, as amounts are typically not disclosed. For transactions outside of the region, two thirds came out of Czechia, Poland and the Baltics and half of them targeted Germany, the US, the UK, France and Italy. On the macro level[78] these investments are getting noticed[79]. Russia, with its investment peculiarities[80], traditionally dominates the pack, with a $407bn stock of outward FDI, an impressive $117bn increase from 2015. Less known is the fact that in 2019 Czechia, Poland and Hungary reached together a total outward FDI stock of $108bn. It is still only half of Austria's stock, but it is growing rapidly: Czechia added $26bn outward FDI since 2015.

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Consolidation in traditional sectors, a tactical approach to the energy transition and a talent-based, not labor-intensive, new economy are among the new opportunities for the region. The region can and should create leaders in their own right, directly connected to the global economy. There is no guarantee of success, but populism and population decline notwithstanding, the region remains dynamic[81] and is well-positioned to exploit the ever-changing opportunities of the coming decades. We might yet bear witness to Central and Eastern Europe's finest economic hour.

Lazard, the world's leading global financial adviser, created six years ago a dedicated team for Central and Eastern Europe, and has advised on some of the largest transactions in the region: the €2.3bn e-commerce IPO of Allegro in Poland, the €7.3bn sale of SAB Miller's CEE beer assets, the €3.7bn purchase of Polish telco Play by Iliad, the €470 privatization of Serbia's Komercijalna Banka, or the $20bn sovereign debt restructuring of Ukraine.

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