Connected
Central and Eastern Europe

Tunnel vision
Energy groups eye plans to pipe gas from the east

Pick of the crop
Ukraine targets leading role in world agriculture

Train delays
Financial restraints hold back rail improvements

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Profit Increase after three Quarters

Raiffeisen Bank International AG (RBI), a leading bank in Central and Eastern Europe (CEE), posted profits for the first three quarters 2012 well above those for the first nine months 2011. Consolidated profit grew by 13 per cent to € 842 million despite a persistent challenging and difficult macro-economic and regulatory environment. Core Tier 1 Ratio increased to 10.2 per cent. With the acquisition of Polbank and its merger with Raiffeisen Bank Polska, RBI will become a leading bank in Poland, one of the largest and most resilient economies in Europe.

Income Statement in EUR mn	**1-9/2012**	**1-9/2011**	**7-9/2012**	**7-9/2011**
Net interest income	2,596	2,724	834	943
Net provisioning for impairment losses	(623)	(782)	(224)	(377)
Net interest income after provisioning	1,973	1,942	611	566
Net fee and commission income	1,120	1,125	400	388
Net trading income	220	293	54	37
General administrative expenses	(2,336)	(2,287)	(818)	(772)
Profit before tax	1,115	1,032	188	153
Profit after tax	889	760	155	82
Consolidated profit	842	745	141	130
Balance Sheet in EUR mn	**30/9/12**	**31/12/11**		
Equity	11,136	10,936		
Total assets	147,128	146,985		
Bank Specific Information	**30/9/12**	**31/12/11**		
Core tier 1 ratio (total risk)	10.2%	9.0%		
Tier 1 ratio (credit risk)	13.1%	12.2%		
Tier 1 ratio (total risk)	10.7%	9.9%		
Own funds ratio	14.8%	13.5%		
Performance	**1-9/2012**	**1-9/2011**		
Return on equity (ROE) before tax	14.1%	13.6%		
Consolidated return on equity	11.7%	11.0%		
Cost/income ratio	60.1%	55.8%		
Earnings per share in EUR	3.55	3.06		
Resources	**30/9/12**	**31/12/11**		
Number of staff	60,632	59,261		
Business outlets	3,115	2,928		

RBI regards both Austria, where it is a leading corporate and investment bank, and CEE as its home market. In CEE, RBI operates an extensive network of universal banks, leasing companies and a range of other specialised financial service providers in 17 markets. In total, 61,000 employees service about 14.1 million customers through more than 3,100 business outlets. RBI's service quality has again been proven in 2012 by several awards.

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Better together

ON THE COVER: a welder works on a 12-metre pipe that will form part of the Nord Stream offshore gas project

Prince Klemens von Metternich, the 19th-century Austrian diplomat, once remarked that when Paris sneezes, Europe catches a cold. For the economies of central and eastern Europe, it is the health of Germany that is critical.

The destination for a quarter of the region's exports, Germany is indelibly interconnected with the economic vibrancy of its eastern neighbours, as correspondent Jan Cienski explains.

The mayors of Zgorzelec and Görlitz – towns on either side of the Polish-German border, which best illustrate the growing links across the region – describe their relationship as that of a "single organism" that is "better together".

Strong historic and economic ties also bind the Baltic states of Latvia, Lithuania and Estonia – even if modern railways do not.

Richard Milne reports on an ambitious proposal to build a high-speed rail line that could boost regional connections with links from the Baltic's biggest cities to Warsaw and beyond.

A very different, but no less ambitious, infrastructure project is already operating in another part of the region: the €7.4bn undersea Nord Stream pipeline that began delivering gas from Russia to western Europe late last year. This, and a host of planned rival pipelines could, as Neil Buckley explains, profoundly affect energy supplies across central and eastern Europe for decades to come.

In the south-east corner of the continent, meanwhile, concern among international financial institutions about the economic problems in the Balkans led to a €30bn growth plan that will be implemented over the next two years.

Yet even amid the gloom there are bright spots: Croatia's holiday industry is booming. The minister in charge tells correspondent Andrew MacDowall that a record number of tourists are expected to visit the country this year.

As the Connected Europe series marks its third year, the region's interconnections have become deeper and more significant.

Robert Orr
Commissioning editor

COVER PHOTO: NORD STREAM AG

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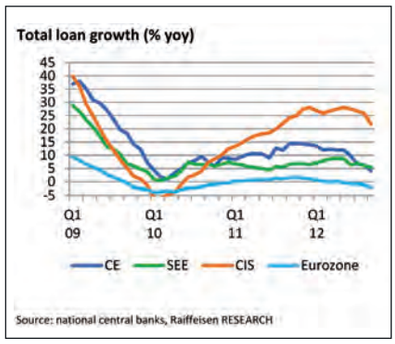
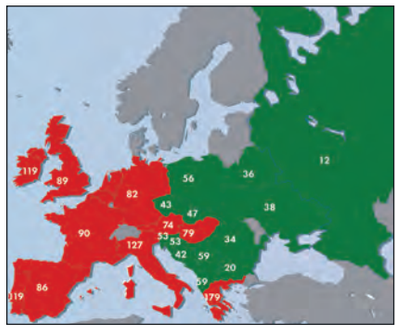
CEE – withstanding a tough environment

Interview with Peter Brezinschek, Chief Analyst of Raiffeisen Bank International

Given the recession in the Eurozone, how is Central and Eastern Europe evolving out of the financial crisis?
After a healthy rebound in economic activity in 2011 we have witnessed a slowdown in CEE growth during 2012 as well. The renewed recession in the Eurozone proved to be a burden on the export relying economies in CEE, where domestic demand was not yet able to bolster growth. In addition, the situation in Eastern Europe shows a rising heterogeneity, Russia, Poland or Slovakia managed to maintain growth figures throughout 2012. Other countries like Hungary, Slovenia and even the Czech Republic once again slipped into recession. During 2013, we expect a moderate economic recovery for the overall CEE region with an overall growth rate of about 2.4 per cent yoy in real terms.





Maastricht criteria fulfilled
Maastricht criteria not fulfilled

What about the current account imbalances, did they adjust?
Especially Southeastern Europe (SEE) and Central Europe (CE) saw rising current account deficits in the era up to the financial crisis 2008. But since then, the CEE region managed to adjust these imbalances and clearly topped the Eurozone periphery in terms of reform willingness and ability to adjust. The current account deficit in CE shrank from almost 6% of GDP in 2008 to 2.1% in 2012. For SEE this adjustment was even faster, as the deficit fell from 14% to just below 5% in 2012. Clearly the difficulties we are witnessing in the Eurozone have their toll on Eastern Europe as well. But while almost all CEE countries should manage to reach the 3% of GDP budget goal in 2013, public debt levels are well below the alarming levels in the Eurozone. Taking an Eurozone average for public debt, we stand at roughly 93% of GDP in 2012. For the entire CEE region we have a public debt level on average of just above 29% of GDP. Only Hungary has a public debt level that exceeds the 60% of GDP Maastricht criteria.

With the banking sector remaining under pressure in the Eurozone, how is CEE evolving in this respect?
The data show that the Eurozone banks are scaling back their international and cross-border activities. This holds especially true for the developed markets such as Spain or Italy where cross-border banking exposure decreased by around 40 to 50% compared to year-end 2007. On the other hand, cross-border banking exposure to CEE and the regions CE and SEE has remained more or less stable for a long period of time and declined marginally in comparison to developments in the Eurozone during 2012. Up to now, the deleveraging by Western European banks in CEE is carried out on a very selective and country-by-country basis. In some challenging markets, where loan books continue to stagnate or even shrink, such as Hungary and Ukraine, banks decrease their exposure substantially, while the effect on other CEE countries was very limited. There is no region-wide credit crunch or funding crunch in CEE. On the contrary, the deposit inflow in the CEE banking sector is currently clearly a stabilizing element for CEE banks. Accordingly, the respective loan to deposit ratios are further improving since the financial crisis emerged.

Is the convergence process of CEE towards the Eurozone in your view intact?
Simply comparing unit labour cost between CEE and the Eurozone gives a clear indication of convergence potential. Compared to Austria, CEE stands at unit labour cost of roughly 40%! This mirrors the extreme cost competitiveness of the region, additionally boosted by productivity enhancement. That's basically a result of flexible labour markets. Nevertheless, despite the strong convergence potential we estimate that we will witness a slowdown in long-term potential output and therefore a slower convergence process compared to the time before the financial crisis. But given the reduction of imbalances, this convergence process in the future can be regarded as more stable and sustainable. The economic growth differential between the CEE region and the Eurozone should still be approximately 2 percentage points per year.

Raiffeisen Bank International

OPINION

SIR SUMA CHAKRABARTI

A call for growth

Unless action is taken, emerging Europe's economic woes have the power to derail two decades of progress

As glimmers of an end to the eurozone sovereign debt crisis appear, emerging Europe is still looking way into the future for its own economic recovery. Battered by external shocks and crises largely not of their making, economies in central and south-eastern Europe, such as Slovenia, Croatia, Hungary and Serbia, are still shrinking, with a return to significant growth not predicted until 2014.

Credit continues to contract in countries such as Hungary and unemployment remains a problem, particularly in the Baltic states, while south-eastern Europe is also the region most vulnerable to deleveraging by western European banks.

The European Bank for Reconstruction and Development has downgraded its forecasts for growth for central-eastern and south-east Europe, in light of the continuing economic slump in the eurozone and the pull-back by western banks. This onslaught on emerging Europe threatens to erode two decades of progress and jeopardises the chance of a more prosperous future for a generation.

But the international community is not just standing by. The World Bank, the European Investment Bank and the EBRD announced plans to inject €30bn into the region as part of a two-year programme to stimulate growth and recovery. Most of the EBRD's €4bn contribution will be dedicated to south-east Europe and targets both the financial and corporate sectors: it is a proactive move to drive growth.

Although many countries in the region must work on public finance, it does not lessen the emphasis on growth: economic growth and fiscal responsibility are not mutually exclusive.

> 'There is no sign of the major reform drive needed to boost growth rates'

The financial support from the international financial institutions in this latest package contains an implicit bargain: we will provide financial and technical support for the implementation of reforms but we expect policymakers to push ahead with structural reforms, too.

At a time when firefighting has been a priority, the pace of structural reform has slowed – some reforms have even been put into reverse. A few countries have adopted populist measures that might appeal to voters but have unsettled investors both at home and abroad. While there has been no wholesale rejection of the underlying reform agenda, the direction is still not right.

As the EBRD pointed out in its most recent transition report: "There is no sign of the major reform drive needed to boost growth rates towards their long-term potential."

The EBRD exists to help push forward the reform agenda, both through its investments and its advice to help develop the regulations and institutional framework for an effective market economy. That policy dialogue covers all areas, from the development of capital markets and new regulations for renewable energy use to guidelines for effective procurement policies for the public sector. With the pace of reform slowing, the bank is attaching greater importance to helping formulate effective policies. One area resistant to the reform process, despite sporadic improvements in a few countries, is the corruption that casts a persistent shadow over the investment climate and stands in the way of modernisation.

The EBRD drive against corruption influences its choice of business partners. It rejects investments where it is uncertain of the probity of individuals concerned, and it sets conditions on other investments to ensure corporate governance and appropriate standards are in place.

In societies where the judicial systems are relatively young, our legal transition team facilitates training for members of the judiciary and helps to develop investor-friendly frameworks to remove legal impediments to doing business. But more can be done: the EBRD continues to ensure that in its work against corruption, its voice is commensurate with the importance of its role as an investor. ■

The writer is president of the European Bank for Reconstruction and Development

Sign of the times: a young protester at an anti-austerity rally in Slovenia

PHOTO: EPA; AFP

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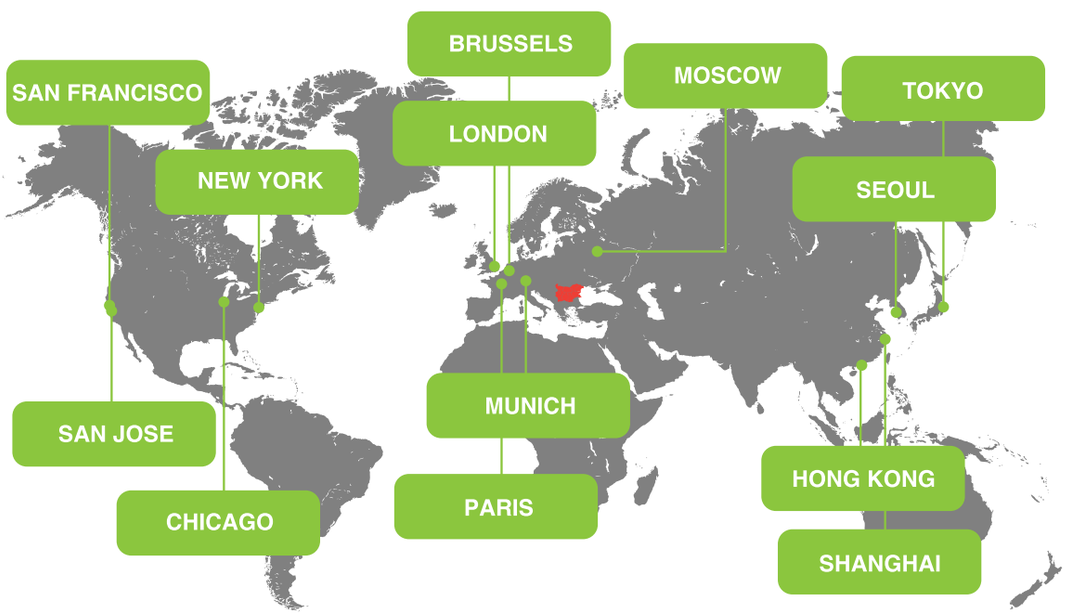

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EMERGING EUROPE
INTRODUCTION

PHOTO: AFP

Red army: Polish fans salute their football team at this summer's Euro 2012 tournament, which the country co-hosted with Ukraine

Goal challenged

The former communist bloc has made huge strides over two decades, but economic worries threaten progress, says **Neil Buckley**

For the countries of central and eastern Europe, the unassailable momentum of integration with Europe's west has been a double-edged sword. For much of the past decade, the wealth gap between west and east has narrowed as inflows of cheap capital helped power economic growth in the former communist countries.

Companies from western Europe, as well as the US, Japan and South Korea, took advantage of new EU members' well-educated, but comparatively cheap, labour to provide a powerful low-cost manufacturing base to supply the rest of the continent. EU funds helped develop modern highways and other infrastructure, starting the process of interlinking the continent and finally consigning the 40-year divide created by the communist-era Iron Curtain to history.

This changed when the 2008 collapse of Lehman Brothers, the US bank, stopped the flow of cheap credit and plunged the global economy into crisis. Several countries in the region were left with severe balance of payments problems; almost all descended into recession. With some exceptions, central and eastern European nations were the hardest hit by the crisis. Four of them – Latvia, Lithuania, Estonia and Ukraine – were in the top five deepest economic contractions in the world.

By early 2010, many had begun to rebound, largely thanks to the recovery in Germany, with whom their manufacturers' fortunes are closely intertwined. As the eurozone crisis deepened in 2011, however, emerging Europe was dragged down once more by the slowdown in its biggest market and source of funds.

While the prospect of Greece exiting the eurozone – endangering the single currency's survival – has receded in recent months, the slowdown has continued.

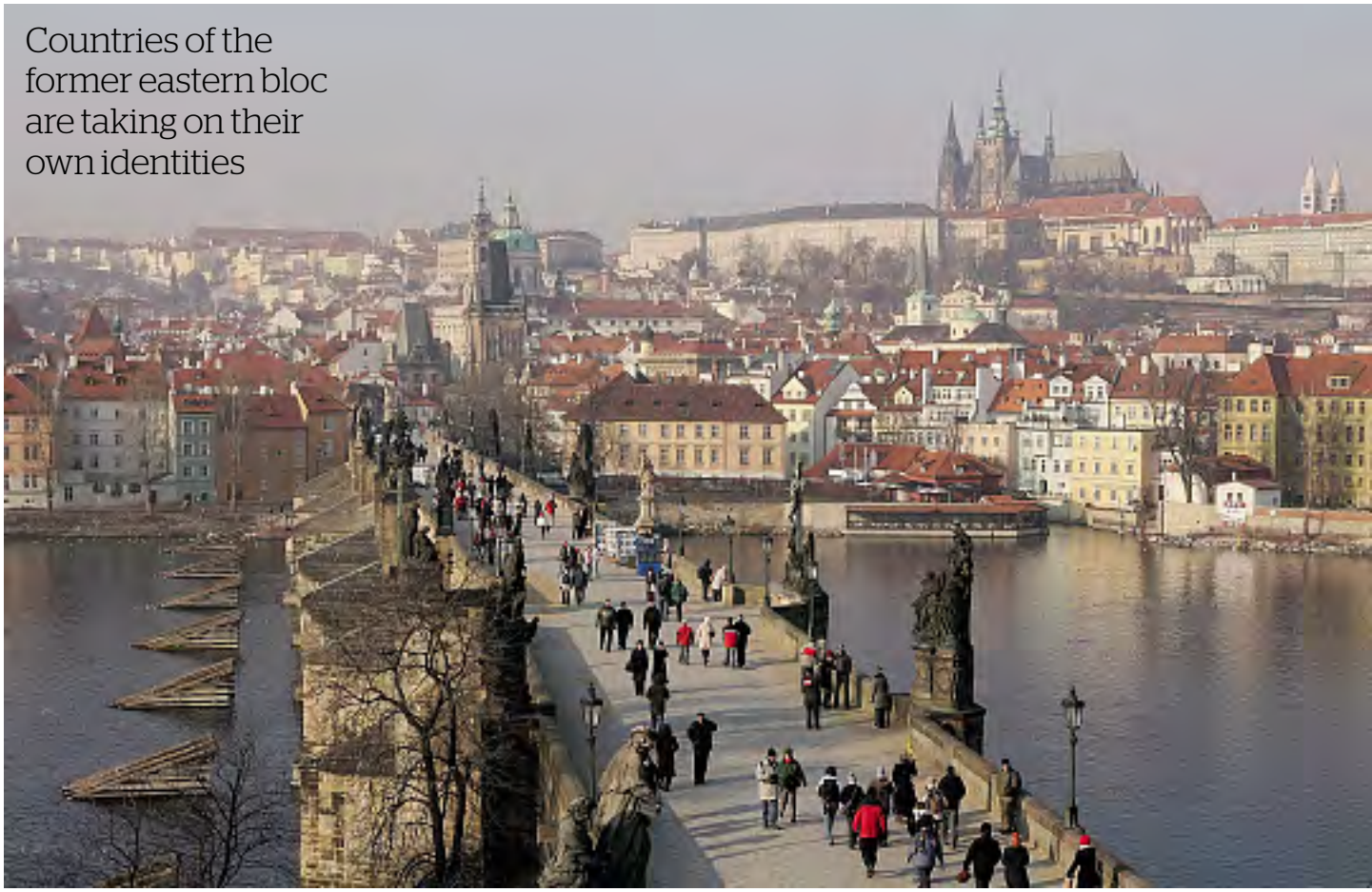
> Emerging Europe was dragged down once more by the slowdown

Concerned about the consequences of that slowdown for the dozen fledgling market democracies in Europe's east and south-east, the European Investment Bank, World Bank and European Bank for Reconstruction and Development came together last month with a €30bn action plan to support the region. Seventeen countries will be eligible for the funds, designed to support growth by investing in private and public sector initiatives, including infrastructure, corporate investment and the financial sector.

The plan builds on a revival earlier this year of the Vienna Initiative of 2009 – when regulators and international financial institutions agreed a pact to prevent the western European ➤

EMERGING EUROPE
INTRODUCTION

Countries of the former eastern bloc are taking on their own identities



banks that dominate the region from withdrawing.

Erik Berglof, the EBRD's chief economist, says the new plan does not reflect fears of a looming collapse, as it did three years ago. "This is less about providing liquidity and lending to financial institutions; it's about a broader range of investments [and] long-term growth issues. We're talking about getting a recovery going," he says.

The good news is that the public finances of many central and eastern European nations are in better shape than some of their neighbours in western or southern Europe. The imbalances that made the region vulnerable four years ago have largely been closed or narrowed.

Some suggest the industrial, economic and financial integration of the past two decades mean there is no longer an east-west divide, but a north-south one – with the more secure and better-performing economies in the north. Indeed, most of them are in more robust economic health than the likes of Greece, Spain or Portugal.

As Jim O'Neill, chairman of Goldman Sachs Asset Management and the inventor of the "Brics" concept, told a conference in Warsaw this year: "A number of the central and east European countries would be more natural and stable participants of the European monetary union" than the eurozone's debt-laden periphery countries.

Bridge the gap: Prague in the Czech Republic, where the economy is forecast to shrink this year

Poland has been the fastest-growing member of the EU since 2008, and was the only one to avoid recession in 2009. The country sealed its success by co-hosting, with Ukraine, the Euro 2012 football championship, the first time the event had been held in eastern Europe since the fall of communism. "We are getting used to seeing ourselves as a member of northern Europe," says Radoslaw Sikorski, Poland's foreign minister.

Yet even talk of a north-south divide is an oversimplification.

A big lesson of the past four years is that while former eastern bloc countries shared many similarities two decades ago – and similar vulnerabilities in 2008 – they now increasingly look

PHOTOS: GETTY; AFP

and perform differently from one another. Many have chosen individual policy mixes to deal with the financial crisis; some are seeing the results, positive or negative, of policy decisions made much earlier in the post-communist transition process.

The result is a complex and sometimes contradictory picture.

While the robust Polish economy is expected to grow another 2.4 per cent this year, Hungary is forecast to experience a 1.2 per cent recession – partly a result of "unorthodox" policies that have hit investment.

Although the Czech Republic and Slovakia are both big in auto manufacturing and are heavily tied to Germany – and among the richest new EU members by output per capita – the former is forecast to shrink 1.3 per cent this year, but the latter to grow 2.6 per cent. This is despite the fact that the Czech Republic has retained its own currency, and hence exchange rate flexibility, while Slovakia is a eurozone member.

Meanwhile, Slovenia, the richest new EU member and also in the eurozone, will shrink the most among them – by an estimated 2.3 per cent this year. There has been speculation that it might need an EU bailout for its banking sector.

Currently the fastest-growing countries in the EU are the Baltic states of Latvia (4.3 per cent) and Lithuania (2.9 per cent), with Estonia's growth also strong at 2.5 per cent, according to recent European Commission estimates. However, it should be noted that all three are bouncing back after double-digit contractions in 2009, when they imposed some of the continent's toughest austerity measures.

The biggest area of concern remains south-east Europe, where the republics of the former Yugoslavia are grappling, to varying degrees, with the setback from the civil wars of the 1990s.

Brics in the wall: Jim O'Neill of Goldman Sachs (above) has praised the region's strengths; Vesna Pusic, Croatia foreign minister (below), has pledged to help others join the EU

The Balkans have also suffered from the fact that too high a proportion of the region's pre-crisis investment went into sectors such as construction and real estate, rather than productive assets such as manufacturing, as it did in central Europe. Parts of south-east Europe are also vulnerable to the economic problems in nearby Greece.

Unemployment is worryingly high too, with a quarter of the workforce without a job in Serbia, and 30 per cent in Macedonia.

> Poland is getting used to seeing itself as a northern European country

The picture is slightly better in Croatia, expected to become the EU's 28th member in July. Vesna Pusic, Croatia's foreign minister, says the country's entry sends an important message to aspiring EU states such as Serbia that membership prospects – and thus incentives to reform – remain alive. Croatia is ready to help its neighbours get through the accession process, for which the bar has recently been raised.

The process of becoming an EU member became harder after criticism from western Europe that Romania and Bulgaria were admitted in 2007 without first making sufficient progress on law and order and fighting corruption.

"Everybody we talk to tells us, 'you are joining now, what will that mean for your neighbours?'" says Pusic. "Never before was a country entering the EU asked so systematically... about its plans for the neighbours." She has called Croatia's EU entry "accession with a task" of pulling other former Yugoslav countries along behind it.

The region's economic woes have led to some worrying political signs.

Romania had a constitutional crisis in July when the government attempted to impeach Traian Bsescu, its president. In May, Serbia elected a nationalist-tinged government led by prime minister Ivica Dacic and President Tomislav Nikolic, a former ultranationalist, though both insist they are pro-EU.

Rosen Plevneliev, president of Bulgaria, warns that high unemployment presents the Balkans with a new danger – that populism and nationalism replace the reforms the region desperately needs.

This would serve "those who don't have a good idea how to reform, or are not honest enough to tell people that reform takes time", he says.

As the EU's preoccupation with solving the eurozone debt crisis grinds on, it faces the problem of ensuring that the process of connecting the continent does not, in its south-east corner, go into reverse. ■

Investment drives closer integration

Ties with the region's economic powerhouse are growing stronger, reports **Jan Cienski**

When Rafal Gronicz was growing up in the Polish border town of Zgorzelec, he used to gaze at the Gothic churches and towers of Görlitz just across the Neisse river in east Germany, knowing a visit was almost impossible.

"It seemed as inaccessible for us as Paris or London. You'd need the same sort of paperwork to go to any of those cities," says Gronicz, now mayor of Zgorzelec.

Today, more than two decades after the end of communism and German reunification, there is no need for a visa or paperwork, and the once impossible journey can be made via the footbridge and roadways that connect the two towns, which were one German city until 1945.

'Germany is one of the largest investors in Poland'

"We are becoming a single organism," says Gronicz. Siegfried Deinege, his German counterpart from Görlitz, adds: "We're much stronger together."

Proof of this can be seen in the growing economic and commercial links between the towns. Polish workers cross the border daily to jobs at companies such as Siemens, the German engineering group that makes steam turbines in Görlitz, and Bombardier, the Canadian trainmaker that is another big employer in the town. Both companies regularly use suppliers in Poland and the nearby Czech Republic, while Siemens has a design office across the river in Zgorzelec.

Cross-border investors include Maxim Gruppe, the German cosmetics company that is building a €44m aerosol canfactory in Zgorzelec to take advantage of the cheaper labour costs and good transport links to both western and eastern Europe, and Polish power distribution systems group TP-Elbud, which recently spent €1m on a factory in Görlitz. "We needed a facility that would allow us to put a 'Made in Germany' label on our equipment to help sales in Germany and the Middle East," says Marek Kaliga, TP-Elbud's production director.

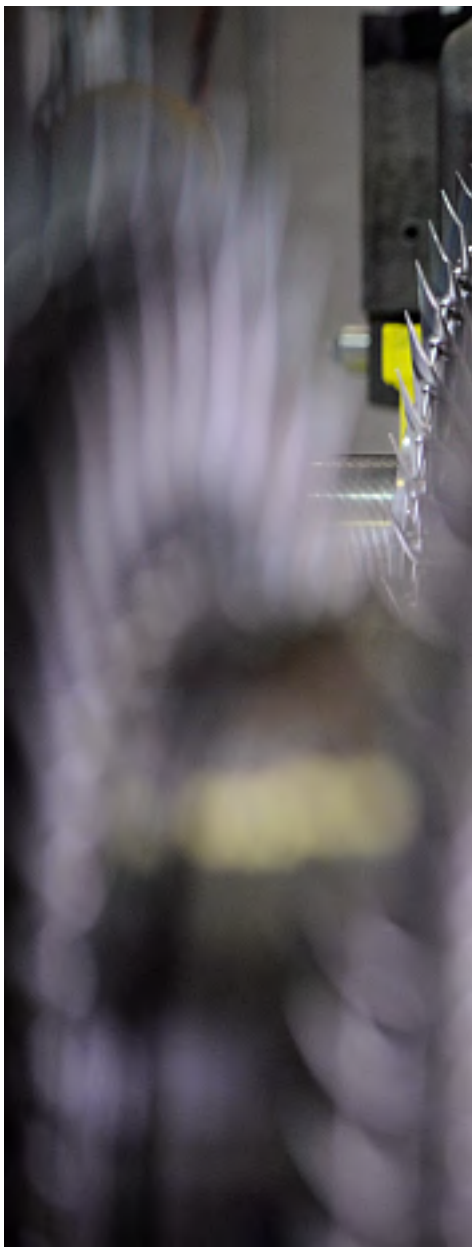
The close links between Görlitz and Zgorzelec mirror the ties that bind Germany to the former communist countries of central and eastern Europe. These ties have been key to the latter's economic progress over the past two decades, while also benefiting Germany by reducing its cost base and opening up new markets.

Germany accounts for about a quarter of exports from the central and eastern Europe region, according to a study by Citibank, and is a vital trading partner particularly for Poland, the Czech Republic, Hungary and Slovakia. ➤

Car plant: the Seat Ibiza model being assembled at Volkswagen's factory in Slovakia

PHOTO: AFP

TRADE LINKS
GERMANY



Economic power: Siemens makes steam turbines in Görlitz (right); the view across the Neisse river to the city's cathedral (below)

It is one of the largest investors in Poland, thanks to about €23bn in cumulative foreign direct investment. German companies have invested the same amount in the Czech Republic, €16bn in Hungary and €9bn in Slovakia.

German companies were among the first to invest following the end of communism. In 1991, Volkswagen bought into Skoda, the Czech carmaker that has become one of the group's most successful brands.

VW also invested in Slovakia while it was still a part of Czechoslovakia. Now the company's large car plant on the outskirts of the capital Bratislava makes high-end SUVs for its Porsche, Audi and VW brands, as well as small cars such as the Volkswagen Up! model.

"Some of the earliest foreign retailers in Poland were German," adds Sean Briggs, managing director at Colliers, the real estate company, in Warsaw, noting that German property investors are still among the most important buyers in the region.

Frankfurt-based Union Investment Real Estate recently spent €390m buying a shopping centre in Lodz, the largest retail property transaction in the Polish market this year. Volker Noack, a member of the German group's management team, says: "We are active in 25 countries and Poland is among the most important. We are deep in the market and essentially a local player."

> 'Poland is a market, not just a production site'

An €800m Mercedes-Benz factory in Kecskemét, Hungary began production earlier this year, largely making its new B-Class compact model.

Daimler, which owns the Mercedes-Benz marque, says production costs are about a third lower than in its home market, adding that the location was chosen because of good transport links to the rest of the company's factories in Germany.

"If you are selling at a premium, as we are, you have to find a location where you can build at the appropriate quality," says Daimler.

The auto sector, and its attendant base of parts suppliers, has in recent years become one of the region's most important exporters, accounting for about 10 per cent of the Czech Republic's exports to Germany and 14 per cent of Slovakia's.

The region's lower labour costs and high productivity have pulled in other German companies keen to outsource functions such as accounting, information technology, finances and customer services. Lufthansa, the airline, has a growing business-processing centre in Kraków.

Smaller companies are also

PHOTOS: AFP; DREAMSTIME

getting in on the act. "The bigger investments were done a decade ago," says Michael Kern, head of the Polish-German Chamber of Commerce, but "there is now a steady flow of investments from mid-sized companies. Increasingly, German companies are looking at Poland as a market, not just a production site."

At the same time, some of central and eastern Europe's most successful businesses are seeking to expand into Germany. Lindner, a Polish coffin maker, has a large presence in the German market, as does Solaris, the Polish bus manufacturer. Krzysztof Olszewski, Solaris's founder, used the experience he gained working in Germany to launch his company. Some companies have even shifted production to Germany, such as Comarch, a Polish IT company, which has had programming centres in Germany for more than a decade.

While the flow of investment into Germany is small compared with the amount heading the other way, it is rising sharply. Foreign direct investment from Poland to Germany rose from €200m in 2007 to €478m three years later, according to Germany's Bundesbank. Czech investment jumped from €134m to €413m in the same period.

However, such tight economic links can also have negative effects on the region. When German demand dropped in 2009, only Poland, with its large domestic market, was able to stay out of recession. With another German slowdown spreading gloom across the region today, both the Czech Republic and Hungary are in recession, while Poland and Slovakia have suffered sharp slowdowns in growth.

Yet this is unlikely to weaken ties. On the Polish-German border, retail is increasingly dependent on customers from the other side of the Neisse, with shops in Zgorzelec catering to budget-conscious Germans, while the high-end boutiques and restaurants in Görlitz now do a quarter of their business with Poles.

"We see real integration," says Agnieszka Korman, who teaches Polish at a Görlitz school attended by German and Polish pupils. "Even the old men sitting in the Görlitz town square drinking beer are pretty mixed." ■

GAS SUPPLY
PIPELINES

PHOTO: NORD STREAM AG

Energy battle

Building pipelines to deliver gas from Russia and the east to western Europe is expensive – and highly political, writes **Neil Buckley**

Ambitious project: Nord Stream is already transporting gas under the sea from Russia to Germany

Boyko Borisov, Bulgaria's prime minister, unrolls a map across a conference table in his office and with his finger traces the dotted lines that snake across his country. At Europe's south-east corner, Bulgaria finds itself at the centre of a multibillion-dollar battle to bring natural gas to the European Union.

Last month, Bulgaria became the last in a chain of Balkan countries to agree to the building of a $16bn (€12.3bn) Russian-backed pipeline across its territory. Known as South Stream, the project is led by Russia's Gazprom along with Eni of Italy, Wintershall of Germany and France's EDF. Construction work on the first leg of the project – 900km from Russia to Bulgaria, under the Black Sea at a depth of up to 2km – is due to begin this month.

According to Borisov, one of South Stream's big pluses is that it connects directly to Bulgaria's shore. The bulk of Russia's gas exports to the rest of Europe have long been shipped through a Soviet-era pipeline across Ukraine. However, those two countries have not always seen eye to eye. Winter price disputes in 2006 and 2009 led to Gazprom briefly cutting off gas to Ukraine – leaving customers further down the line shivering because of supply disruptions.

"The gas supply was switched off when the temperature was 20 degrees [Celsius] below zero, and Bulgaria was hit," says Borisov, jabbing at the map. "We learned our lesson, and we are going to take measures to prevent it from recurring."

As Europe strives to build high-tech transport, communications and energy networks spanning the continent, gas pipelines are among the most ➤

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controversial. They combine ambitious engineering and high finance with a hefty slice of geopolitics.

At the heart of it lies a central conflict. On the one hand is Russia's desire to expand export capacity to Europe. In recent years, Moscow has also sought either to bypass Ukraine or to persuade it to sell Russia control of its gas transit pipeline, to avoid any future disruptions, though this aim is less overtly stated.

> Russia has sped up plans to construct two pipelines in a 'pincer movement'

"South Stream's contribution to providing Europe with energy security is very significant. It allows us to create alternative and secure natural gas supply routes to our consumers," Alexei Miller, Gazprom's chief executive, said last month.

South Stream has first-mover advantage over rival EU-backed plans to bring gas from the Caspian Sea basin and the Caucasus. The EU, backed by the US – and spurred on partly by those trans-Ukrainian shut-offs – is keen to reduce its reliance on Russian gas and diversify sources of supply. The result has been intense competition between the Russian- and EU-backed projects.

Since the middle of the past decade, Russia has accelerated what some analysts have called a "pincer movement" to construct two new sub-sea pipelines. South Stream would cross the Black Sea and enter Europe from the south, while Nord Stream runs under the Baltic Sea from north-west of St Petersburg to northern Germany.

However, the fact that Nord Stream bypasses not just Ukraine but also other "transit" states such as Poland has led Radoslaw Sikorski, Poland's foreign minister, to compare the project to the Molotov-Ribbentrop pact between the Soviet Union and Germany, which led to Poland's partition before the second world war.

The fear among central and eastern European countries is that Russia will be able to apply pressure by threatening to cut off their gas supplies without affecting deliveries to western Europe.

Nord Stream's first line, built by a consortium of Gazprom with Germany's Eon and BASF, Gasunie of the Netherlands and France's GDF Suez, began delivering gas directly to the EU at the end of 2011, with a second line inaugurated in October.

When fully operational, the €7.4bn Nord Stream project will carry 55bn cubic metres (bcm) of gas a year – enough for 26m households – into Germany, from where it will be piped to the Netherlands, Denmark, France and the UK. That compares with an export capacity of 150bcm annually across Ukraine.

Signed up: Dmitry Medvedev, Russia's prime minister, demonstrates political support for the new pipeline

PHOTO: REUTERS

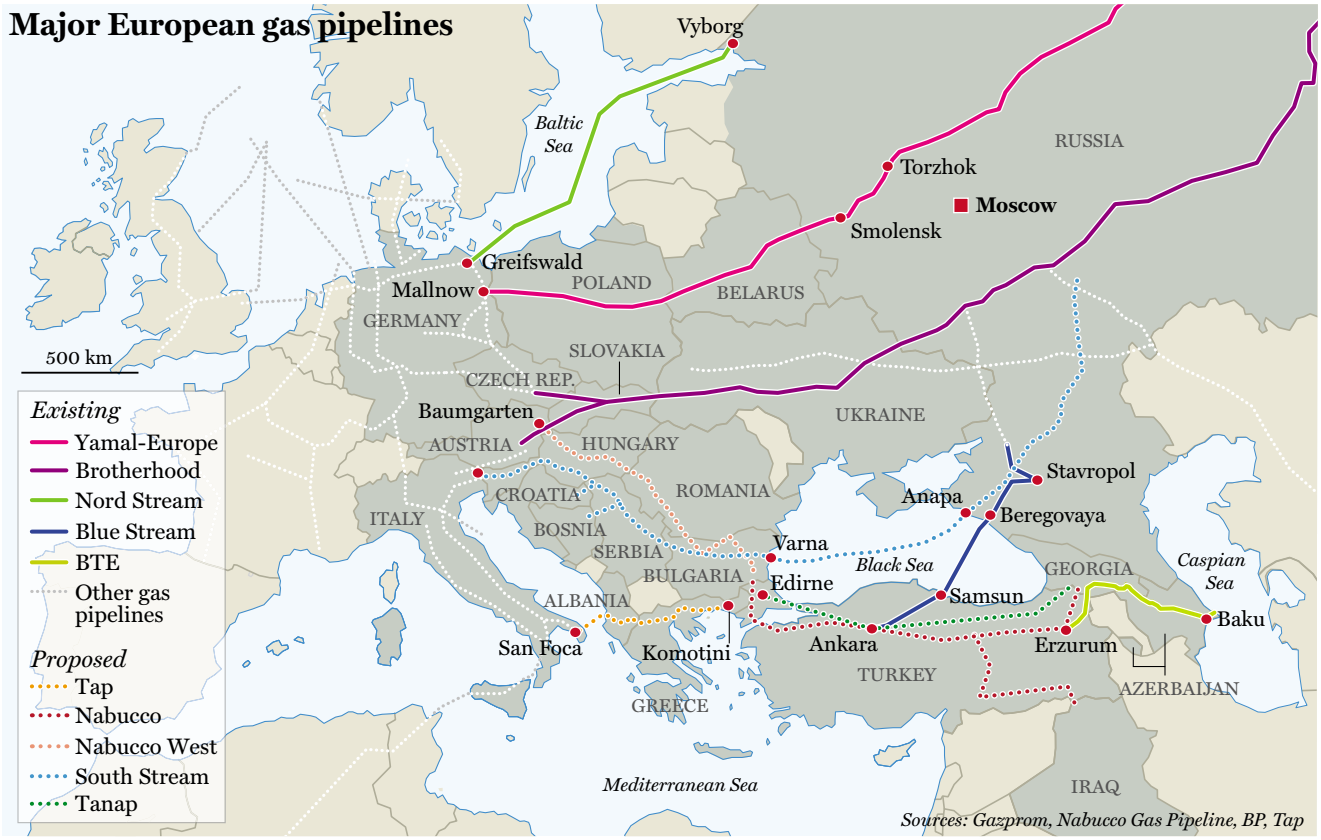
The 63bcm South Stream initiative, by contrast, is in competition with the EU-backed Nabucco project – intended to bring gas from the Caspian basin through what Brussels calls the "southern gas corridor" across the Caucasus and Turkey.

This has left central and south-east European countries along the route of the projects anxious to secure at least one of the pipelines across their territory. While the state gas companies of Romania, Bulgaria and Turkey have joined Austria's OMV, Hungary's Mol and Germany's RWE in the Nabucco consortium, some of the same countries have also signed deals with South Stream.

Nabucco has struggled to sign up gas supplies to fill its 31bcm capacity. Over the past year, however, plans to bring gas through the southern corridor have evolved into a new form with a guaranteed gas supply: Azerbaijan's Shah Deniz field in the Caspian Sea.

The plan is for Shah Deniz gas to travel across Azerbaijan and Georgia to Turkey via an upgrade to the existing BTE (Baku-Tbilisi-Erzurum) pipeline. That would link with the Trans-Anatolian Pipeline (Tanap), a joint Azeri-Turkish project unveiled late last year that would run across Turkey to the European border.

Two projects are now vying to carry the gas onward from Tanap to central Europe. One is a shortened version of Nabucco, called Nabucco West, from Bulgaria through the Balkans. The other, the Trans-



Adriatic Pipeline (Tap) would run across Greece and the Adriatic to Italy.

The Shah Deniz consortium partners, which include BP, Statoil and Socar, Azerbaijan's state energy company, are due to decide between the two European options next year.

They have also moved to create a more integrated project by signing a cooperation agreement with Tap, along with its existing shareholders EGL of Switzerland, Norway's Statoil, and Germany's Eon Ruhrgas. They are in talks to do the same with Nabucco.

While some Nabucco shareholders, including Germany's RWE and Hungary's Mol, have shown signs of restiveness, Christian Dolezal, the project's communications director, insists all are fully committed. "All the decisions that have been strategically important for Nabucco have been taken by the entire consortium. So that shows the commitment is there to deliver on the project," he says.

Tap and Nabucco have each expressed confidence that their option has advantages over the other. Both, in turn, also insist the EU-backed project has advantages over South Stream as, unlike the Russian-backed project, it will bring gas from a new source.

"With South Stream, we are going to have a route substitute and a volume substitute that won't change anything with regard to liberalising the European gas market," says Dolezal. "Nabucco would realise this market liberalisation, and create a whole new marketplace in this area."

Michael Hoffmann, external affairs director at Tap, similarly says his project would diversify supply sources for European markets – particularly Italy, which relies on imports for 90 per cent of its gas needs. Italy could then have the ability to act as an energy hub to supply other countries in central and western Europe by reversing the flow of pipelines that currently take gas into the north of the country.

Some independent observers have also questioned the viability of South Stream.

"There is no basic market-driven reason why South Stream would happen," says Ilian Vassilev, an energy consultant and a former Bulgarian ambassador to Moscow. "You have a number of alternative sources of supply, and the demand isn't there." ■

Signs of unrest

Central and eastern Europe has been caught up in a crisis not of its making, writes **Tony Barber**

For the governments, businesses and citizens of central and eastern Europe, no Christmas present would be more welcome than firm evidence that eurozone leaders are at last subduing their sovereign debt and financial sector crises. Uncertainty about the eurozone's future is arguably the blackest cloud that will block the sunshine of economic growth from warming central and eastern Europe in 2013.

True, the outlook is somewhat more settled than it appeared five months ago. Regional leaders now have the clear impression that European policymakers intend to do their best to keep Greece in the eurozone. This is drawing the curtain on months of anxious speculation and is calming nerves above all in the Balkans, where the spillover effects of a Greek exit might be highly destabilising for local banks and businesses.

It is also a positive sign that no big financial institutions have failed in central and eastern Europe in spite of continuous funding pressures on their eurozone parent banks. Most of the region's banking system is foreign owned, mainly by lenders in Austria, Greece, Italy and Nordic countries, and it will remain vital that parent banks do not cut adrift their subsidiaries.

The European Bank for Reconstruction and Development and the Vienna Initiative, a group of global lenders, regulators and policymakers, see a worrying trend in the scale of funding withdrawals since mid-2011. According to the EBRD, this has caused sharp credit contractions in countries such as Hungary and Latvia. But the retrenchment of western European banks reflects, in some respects, the bursting of the credit bubble that had encouraged excessive borrowing in central and eastern Europe up to 2008.

> There have been credit contractions in Hungary and Latvia

Across the region, economic growth in 2013 is likely to be moderately higher than this year, largely because of a mild eurozone recovery. According to Consensus Economics, a forecaster, five central European countries (the Czech Republic, Hungary, Poland, Slovakia and Slovenia) will grow at an average rate of 1.5 per cent, up from 1 per cent this year.

The same is predicted for seven nations in south-east Europe (Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the former Yugoslav republic of Macedonia, Romania and Serbia), up from 0.2 per cent this year.

However, these averages conceal considerable differences. For example, Slovenia, a eurozone member severely affected by the world financial crisis, is expected to remain in recession next year. Its mostly state-owned banks are labouring under €6.5bn of ➤

Taking to the streets: Slovenia's main unions organised a protest against government austerity measures

PHOTO: AFP

bad loans, or about 18 per cent of annual economic output, and need extensive recapitalisation.

Until now, Slovenia has defied predictions that its troubles will prove so overwhelming that it will need aid from the eurozone's emergency rescue funds. The most dangerous moment was in August, when the country's 10-year government bond yield rose above 7 per cent. Then, in early September, the European Central Bank eased the concerns of investors by promising to launch a potentially limitless programme of eurozone sovereign bond purchases.

In October, the government successfully issued a $2.25bn, 10-year bond at a yield of 5.7 per cent. This covered all Slovenia's financing needs for the rest of 2012, and more than half its projected public borrowing for 2013. However, parliamentary opposition to the government's structural reform plans means that the risk of a eurozone bail-out still hangs over Slovenia.

Countries in central Europe and the Baltic region are particularly exposed to eurozone turmoil. For most of the crisis, Poland has been the region's star performer, generating steady growth when the rest of the EU was either in recession or nursing itself back to recovery. Poland benefited from healthy domestic demand and a floating exchange rate that helped exports, as well as billions of euros in EU regional aid funds and the comforting knowledge that an International Monetary Fund credit line was available if needed.

Now the outlook is less bright, though hardly disturbing enough to threaten Poland's reputation as central Europe's economic pace-setter. In September, the government cut its 2013 growth forecast to 2.2 per cent from 2.9 per cent, a revision that reflects the impact of higher central bank interest rates and less buoyant exports to the eurozone.

Market forces: a shopkeeper in Budapest. Hungary has been hit hard by turmoil in the eurozone

Polish manufacturers are tightly integrated into cross-border production chains with eurozone companies, especially those in neighbouring Germany. Slower growth in Poland's main trade partners makes itself felt at home. In the first nine months of this year, a slump in western European demand for new cars caused vehicle output at Polish plants to drop by 22 per cent from last year.

Poland nevertheless continues to attract large sums in foreign investment, and its banking sector is solid. The government has displayed a disciplined but pragmatic approach to meeting its budget deficit targets, which augurs well for its ability to navigate through next year's choppy waters.

> Slovenia has so far defied predictions that it will need aid from rescue funds

The outlook in Romania and Serbia is less reassuring. Romania's economy is only just emerging from a deep recession, and its recovery has come at the price of a weak currency and an annual inflation rate that in October rose to 5.3 per cent. The nation is exposed to the eurozone through close commercial and financial ties that include Greek control of about a sixth of the Romanian banking system.

Of equal concern to the IMF and foreign investors is the bitter rivalry between Traian Basescu, the centre-right president, and Victor Ponta, the centre-left prime minister. All are hoping that this month's elections will end this antagonism and clear a path for the next government to embark on the structural economic reforms and privatisations needed to strengthen the economy over the long term.

PHOTOS: BLOOMBERG; AFP

Like Romania, Serbia suffers from high inflation, which reached 10.3 per cent in September and is expected to continue rising into the first half of 2013. Serbia's problems are compounded by disorderly public finances, mass unemployment and poor industrial competitiveness.

To cap everything, Serbia has upset the IMF by breaking agreed spending limits and undermining the independence of its central bank. In February this caused the IMF to suspend a €1bn loan programme. The fund nevertheless sent a mission to Belgrade last month with the aim of completing talks on a fresh loan next year.

Whereas Serbia is many years from joining the EU, let alone adopting the euro, Latvia entered the EU in 2004 and hopes to get the green light next year to join Europe's monetary union in 2014. However, it is not lost on EU policymakers that Latvians approach eurozone membership partly from a desire to seal their independence from Russia. At times they seem less interested in whether their economy and financial system are well primed for long-term convergence with the eurozone.

Early entry is therefore not assured, even though Latvians think their nation is on course to fulfil the necessary criteria. Eurozone governments are scarred by the memory of having allowed countries such as Greece to join the club too soon. As Jörg Asmussen, a German member of the ECB's executive board, cautioned in June when speaking in Riga: "Very careful preparation is required to make sure that convergence continues also after euro adoption... The decision to adopt the euro is a very fundamental one and should not be taken lightly." ■

Worst fears of banking sector crisis are averted

Worries of regional collapse have not come to pass

If ever there was a story of the dog that didn't bark, it is central and eastern European banking and its predicted shrinkage, *writes Patrick Jenkins*.

A year ago, as western lenders found themselves under pressure on capital and liquidity, there was a consensus view that a credit crunch was looming across the region.

Foreign financial services groups, mostly from western Europe, controlled a large part of eastern Europe's banking system, and banks such as Italy's UniCredit, Austria's Erste and Raiffeisen and France's Société Générale – all under pressure on capital – had been expected to shrink their balance sheets.

> A year ago there was a consensus of a looming credit crunch

It never really happened. First, because pressure on capital – heightened by tougher demands from regulators – abated as banks complied more creatively with the rules. Second, liquidity became plentiful thanks to an injection of €1tn of cheap money through the European Central Bank's longer-term refinancing operation.

The result has largely been a maintenance of the status quo. There have been a few ownership changes, notably the sale by Belgium's KBC of its Polish assets to Spain's Santander.

For most foreign banks in the region, the market has been less bleak than the one at home.

"It has been worthwhile for western European banks to diversify into eastern Europe," says Stefan Nedialkov, an analyst at Citigroup. "While eurozone growth should be negative this year and next, at minus 0.4-0.7 per cent, growth in eastern Europe should be in the 2-3 per cent range. However, growth in the region would be hit hard if exports to Germany slow down meaningfully."

A combination of economic outlook and aggressive tax policies has been damaging for banks in Hungary. Erste Bank has been particularly vocal about diverting capital away from the country.

Romania looks promising, but some banks there still suffered in 2012, as Greek banks with operations in the country launched a price war to garner deposits, hurting margins for themselves and others who had to compete.

However, analysts at Morgan Stanley warn that fears of a credit crunch could come true, as the mild 5 per cent fall-off in credit supply from European banks this year risks turning into something far worse. "We believe lack of demand potentially masks the supply-side dynamics," analyst Magdalena Stoklosa says. "We now look to the recovery years from 2014 to see the real consequences of deleveraging, in terms of how credit supply constraint may impact GDP growth." ■

„We are very well positioned in all growth markets“

Interview with Herbert Stepic, CEO of Raiffeisen Bank International (RBI)

Central and Eastern Europe (CEE) is still going through difficult times. Do you sleep well?
I would rather say that Europe is in a difficult process and CEE is suffering in certain instances as a consequence. But compared to the established European markets, CEE is doing surprisingly well, and I generally sleep well.

Would you say that CEE is in a better shape than some of the Eurozone-countries?
Most of the CEE countries have used the time since the first crisis in 2008/09 to do substantial homework. They are now much less vulnerable to external shocks than before. They are less dependent on external financing due to lower current account deficits. Additionally, wages have developed moderately, after the rapid increase in the years before 2008. We have therefore seen productivity gains in most countries in comparison to the Eurozone. What is even more important: CEE countries have significantly lower public debt than Western European countries, although I have to exclude Hungary in that respect. The region also benefits from its catch-up-process and continues to be the continent's growth engine. While at 2.4 per cent, the overall economic growth forecast for 2012 is well below the 3.7 per cent achieved last year, it is still almost 3 percentage points higher than the Eurozone's. However, it is clear that CEE is also in a "new normal" situation. GDP growth as well as banking sector growth will be at a lower, but far more sustainable level in the years to come compared with pre-crisis times.

What is the overall situation regarding the banking industry, both in Western Europe and in CEE?
Obviously, we have seen easier times, but this applies for practically any industry. However, the political,

financial and public pressure on banks is unparalleled to anything I have witnessed in my long career. We have to comply with new regulatory requirements imposed at very short notice not only on the European level and in Austria, but also in a number of CEE countries. While I am happy to report that we clearly surpassed the ratio set by the European Banking Authority, it was still a tremendous exercise, absorbing huge manpower capacities. To make things even more difficult, and contradicting the regulators' objectives of higher capital ratios, we face banking levies in a number of states that are based on assets rather than profits. RBI will be paying about € 160 million in such levies in 2012. And finally, the pressure of public opinion, triggered by a row of scandals that are by no means representative for the whole industry, is weighing down on both banks and their regulators.

Is CEE better off in that respect than the Western part of the continent?
Yes. The changed environment has a greater impact in Western Europe than in CEE. This is due to the fact that the degree of financial intermediation, as measured in aggregated balance sheet totals over aggregated GDP, is much higher in the Eurozone at more than 350 per cent than in CEE at between 80 per cent in Russia and 100 per cent in Central Europe. However, as in Western Europe, we will see a consolidation process, albeit to a much lesser extent. We have seen some banks without a clear regional strategy divesting in the region. Also some Greek banks have exited and a number of other Western banks, having started their operations in Russia rather late, decided to leave that country again.

RBI seems to do quite well in Russia.
Yes, it does, and it pays off that we had already started in Russia in the mid-1990s and expanded by an acquisition that significantly boosted our retail business. We have almost 200 branches and are particularly strong in the Moscow region. The development in the Russian retail business remains very promising with a two-digit increase of loans

and deposits. In 2011, Russia more than compensated our considerable loss in Hungary, while in 1998 it was Hungary, which helped us to mitigate our losses caused by the Russian financial crisis. This diversification by markets, but also by customers and products, is a fundamental part of our successful business model.

Apart from Russia, where do you see growth potential?
We currently see five other markets with a considerable growth potential: Poland, Romania, the Czech Republic, Slovakia and Austria. Poland did extremely well during all the years of the crisis, and with the recent acquisition of Polbank we are ready to play a more vital part in the local banking industry. In Romania, and this is quite in contrast to our peer group, our good performance continues with a bottom-line growth of 20 per cent year-over-year for the first nine months of 2012. The Czech Republic and Slovakia are very solid markets with growth potential for us even though we are already well established. And Austria, our home base, continues to perform far better than the average of the Eurozone. All in all, we are well positioned in these growth markets!

And which markets do you see critical?
Hungary is a very difficult issue, because what happens there is not really compatible with what one can expect in terms of legal security and predictability in the European Union. The government is using the banks more in a self-service mode than in a partnership arrangement, and the country may have to pay the price for that. The current situation is definitely a significant stress factor for any bank, but specifically for foreign-owned banks. But we have no intention of leaving Hungary for the time being. Another difficult market is Slovenia, where we will re-scale our business due to the relatively small size of both the market and our bank and indeed the high level of competition. In this challenging environment for our industry, allocating resources as efficiently as possible is one of the key factors for success.

How do you see the non-performing loans issue?
I am increasingly positive here. As compared with the first nine months of 2011, provisioning for impairment losses fell by € 158 million to € 623 million. For example, we had significant reductions in Hungary, although the level there continues to be high, and also in Russia. Our NPL-ratio, however, increased since year-end by 1.4 percentage points to 10.0 per cent on account of various factors; for instance the consolidation of Polbank, currency effects and some individual cases with large corporate customers. And we have sold some non-core assets in the first half, thereby reducing the calculation basis. I want to emphasize, though, that we have a relatively high coverage ratio of presently 66 per cent, without taking into account collateral that we hold for these loans. When talking about NPLs, one has to be aware that lending in CEE is generally done on a secured basis. So we have very few loans out of the past on an unsecured basis.

So risk remains one of your main focus areas?
Definitely, but a healthy risk awareness and judgment is a key component of any successful banking operation. But of course we focus on other areas, too. As stated before, we foster selective growth in attractive markets by means of our relationship-based business model concentrating on prime corporate and retail customers. We will also further exploit business potential with prime customer relationships arising from market consolidation. We continue to implement process improvements and even tighter cost management. Excluding Polbank, 2012 shows a flat cost development until now, which means that we digested inflation of around 5 per cent across CEE. And we will continue with the optimisation of excess liquidity to further improve our net interest margin. Last, but not least, having closed the acquisition of Polbank, we now focus on integrating it into our Group as well as on rolling out business initiatives and realising relevant synergies.

CEE continues to be the continent's growth engine

Do you plan a capital increase?
We have been stating for a while, and continue to do so, that a capital increase continues to be a possible option depending on market developments. Currently, we do not consider the market environment as favourable, with a share price below that of our IPO in 2005, when we issued at € 32.5. However, with a core tier 1 ratio well above 10 per cent, we do not see a necessity to tap the capital markets.

And when do you plan to pay back the participation capital?
We feel no pressure to do so and do not have any concrete plans. We will, of course, inform the market in time, but before that, we will of course discuss any decision with the Austrian regulators.

Would you recommend a company to invest in CEE and if so, why would you do so?
I would definitely recommend it, and I give you a handful of reasons: the proximity to EU markets combined with relatively low operating costs and favourable tax regimes. The growing domestic markets with more than 300 million potential consumers. The predictable business environment in practically all, and EU regulatory framework in many countries. Compared to many other emerging regions, the reasonably well developed infrastructure, with ongoing investment needs. And finally, but very importantly, the well educated, skilled and ambitious people all over the region. I guess that this is quite convincing, CEE offers a lot of opportunities!

Raiffeisen Bank International

Basket of promise

With some of the most fertile land in Europe, Ukraine has ambitions to be a leading player in world agriculture, says **Roman Olearchyk**

With its rich black earth and bountiful supplies of grain, Ukraine was once known as the "bread-basket of Europe".

Wars were fought between Russia, Poland and the Ottoman Empire for control of the land and its precious *chornozem*, the layer of topsoil that makes the country so fertile.

Today, two decades after the collapse of the Soviet Union, Ukraine is again seeking to establish itself as a significant exporter of wheat, barley and corn, as well as oil-bearing crops such as sunflower seeds.

Bumper crop: Ukraine is a significant exporter of wheat, barley, corn and oil-bearing seeds

After falling to lows of 20m tonnes during the 1990s, annual harvests have rebounded in recent years to more than twice that level, harvesting a record 57m tonnes in 2011. With the right investment and modern farming technology, Ukraine could double its production of grain and oilseeds over the next decade, according to the European Bank for Reconstruction and Development, which has invested nearly $1.5bn in the country's agribusiness sector.

The world's largest grain trading companies have recognised Ukraine's potential, with the likes of Cargill, Toepfer, ADM and Bunge investing billions of dollars over the past decade in building modern storage, processing and logistics facilities.

Despite widespread corruption and bureaucratic hurdles, international food groups such as Kraft and Nestlé have ➤

FARMING UKRAINE

also established themselves in everything from biscuits and chocolates to potato crisps and breakfast cereals.

One issue for Ukraine, however, is that its crop yields remain stubbornly low – a third of the EU average – due to heavy reliance on inefficient farming techniques.

To combat this, agriculture technology groups such as Monsanto and DuPont Pioneer are seeking to help Ukraine boost harvests by providing higher quality seeds and other agriculture products. Jeff Rowe, regional director, Europe for DuPont Pioneer, says his company has built a logistics centre to support strong sales growth in Ukraine, and has begun construction of a $40m seed production facility in the country.

"DuPont Pioneer sees Ukraine as one of the fastest-growing agriculture markets in the world and an important player in the global food security issue," Rowe says. Ukrainian agriculture is rapidly modernising, and the company is confident that the country will reach the government's goal of 80m metric tonnes of grain by 2015, he says.

Achieving this could double the $12bn of annual foreign currency earnings that flow into cash-strapped Ukraine from the export of grain. And that is only the beginning. Rather than just exporting its grain, Ukraine could use its crop surpluses as feed for livestock, converting it into higher-value meat and poultry products, the EBRD says.

George Logush, a former vice-president at Kraft who built up the US group's Ukrainian business in the 1990s, says: "Ukraine is an ideal food-export platform. It has a qualified workforce that is not expensive, good logistical lines to markets – we are right in the middle of key markets – and most of the food ingredients are here."

Ukrainian agriculture commodities are exported freely to the Middle East and African markets, but trade restrictions currently keep Ukrainian valued-added food products out of the EU. However, this could change should Kiev and Brussels sign a free-trade agreement in the coming years.

A proposed deal is currently frozen amid concerns about a rollback of democracy under the rule of Viktor Yanukovich, Ukraine's president; but diplomats say the agreement is likely to be signed in the near future. "Ukraine will become the bread and meat basket of Europe... three to four years after the free trade and association agreements are signed," Logush says.

> To lure foreign investment, Ukraine plans to lease out huge tracts of arable land

This is likely to lead to some of Ukraine's leading agriculture barons becoming "major global players" in both grain and valued-added food products, such as processed and frozen meats, Logush says.

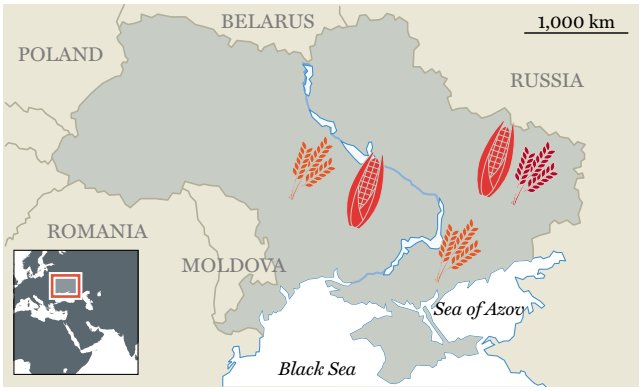
Among those expected to become big participants is Yuriy Kosyuk, co-owner of London-listed MHP, Ukraine's largest poultry producer.

Harvest time: Ukraine's harvests have risen sharply in recent years (below); Oleg Bakhmatyuk has made his fortune from eggs and egg products (above right)

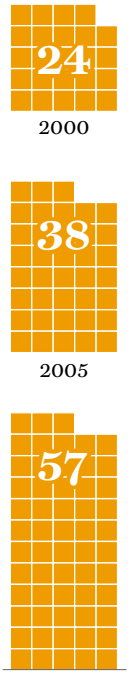
The recent opening of a production facility in the Vinnytsia region of western Ukraine could help MHP become the leading poultry producer in Europe, says Logush, who previously worked for the company.

Also listed in London is Oleg Bakhmatyuk's Avangardco, one of the world's largest producers of eggs and egg products. Unknown to most Ukrainians only a few years ago, the 38-year-old Bakhmatyuk today strikes deals as far away as China, where this year he

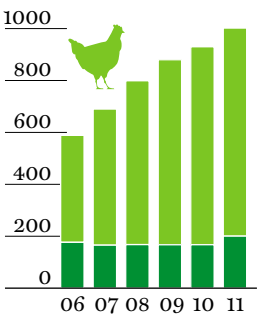
Ukraine's growing agricultural business



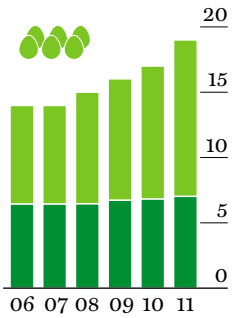
Total grain production (tonnes, m)



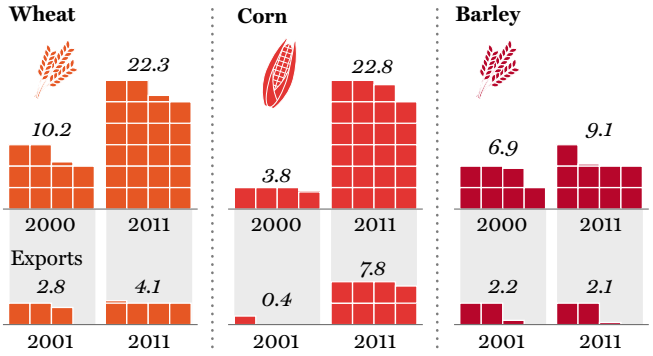
Poultry production (tonnes, '000)



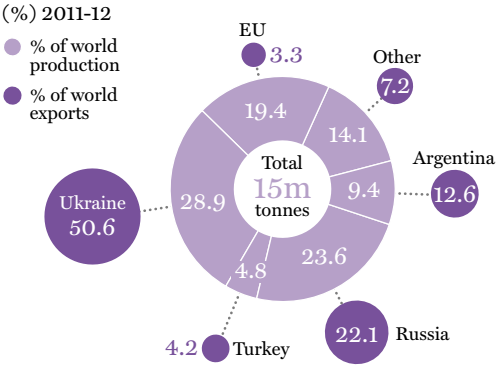
Egg production (m)



Production (tonnes, m)



World oil sunflower seeds producers and exporters (%) 2011-12



Sources: Dragon Capital, SSC, USDA

held talks on multibillion-dollar loans and corn export deals.

"A new generation of strong agribusiness entrepreneurs has emerged," the EBRD notes, adding: "They could soon invest outside the country."

A further hindrance for Ukraine is that the large domestic agriculture conglomerates hold much of the land through long-term lease agreements. Some analysts argue that a longstanding moratorium on agricultural land sales helps to keep billions of dollars of badly needed investments at bay.

To lure in more foreign investment and boost harvests, Kiev's government is floating a bold plan to lease out millions of hectares of unused, government-owned farmland to foreign investors from Europe, China, the Middle East and Africa.

Mykola Prysyazhnyuk, agriculture minister in the most recent Ukrainian government, says investors will soon be offered 50-year leases, tax-free status and unlimited export rights for crops farmed on 2m-4m hectares of arable land not currently being farmed. If the pilot project proves successful, the country could offer more land in future.

Ukraine currently has about 34m hectares of arable land, equal to about a third of the arable land area of the whole EU, with a further 10m hectares farmed either inefficiently or not at all, Prysyazhnyuk says. "I am confident this project will be realised within two, three years," he adds.

Details are still being worked out, but a government presentation says foreign investors signing up to the scheme will join production-sharing agreements or public-private partnerships. Prysyazhnyuk says this will give Ukraine the option to lay aside a share of crops harvested by investors for emergency reserves, or to have a share in profits generated from exports.

"Investors will be given guarantees that exports will be unrestricted. The state will ensure its land is farmed with the highest of technologies," Prysyazhnyuk says.

If they can do this successfully, Ukraine's past as the granary of Europe could yet be revived. ■

PHOTOS: BLOOMBERG; AFP. PREVIOUS PAGE: EYEVINE

Waiting for a train

Despite two decades of planning, construction of the Rail Baltica high-speed link remains some way off, reports **Richard Milne**

As a symbol of how disconnected the three Baltic states can feel from the rest of Europe, little is as potent as railways.

Trains in Estonia, Latvia and Lithuania run on a different gauge to those in western Europe, using the Russian 1,520mm, rather than the 1,435mm favoured from France to Poland. There is not even a rail connection between the three countries themselves. But, in a project whose significance goes well beyond a simple railway line, there is a renewed push in the region to build Rail Baltica, a high-speed train line that would run 950km north/south from Tallinn to Warsaw and then on to Berlin and the rest of Europe.

"It is rather important. One reason is political/philosophical: a conceptual kind of importance," says Juhan Parts, Estonia's minister for economic affairs. "We are in the process of integrating into Europe and we need to improve our infrastructure. Not just railways but electricity and energy, too."

The route would link Tallinn and Riga, the capitals of Estonia and Latvia, as well as Kaunas, Lithuania's second city, although, crucially, not the Lithuanian capital Vilnius. With trains travelling at up to 240kph, a trip from Tallinn to the Polish-Lithuanian border would take about four hours, Parts says, noting that this journey is all but impossible by train today.

There is even a suggestion that a tunnel could one day be built from Tallinn to Helsinki – which would be longer than the Channel Tunnel between England and France – to include Finland in the project, although few think this is realistic any time soon.

Even without the tunnel, the plan would involve not just passenger travel but also the transportation of freight from the Baltics and Finland to the rest of Europe. "Our whole political thinking is that we are on the geographic periphery of Europe, but we want to be at the economic heart," says Alex Stubb, Finland's European Union and trade minister.

> 'We are on the periphery of Europe but we want to be at the economic heart'

But moving the project beyond the vision is proving difficult. The concept of a pan-Baltic railway was first discussed in 1992 by ministers who set up a group called "Vision and Strategies around the Baltic Sea 2010", which issued a report two years later.

By 2001, the Rail Baltica concept had become concrete and it was made a priority project by the European Commission in 2003. Since then, however, it has not progressed much beyond a proposal. Rail Baltica's official website dates from 2005 and has been updated rarely. Officials worry that people have become so used to talking about the project that getting it up and running will be difficult. "We have to make the project materialise and not just have a concept," says Parts.

It is an issue that extends into other pan-Baltic infrastructure projects: a plan to build a nuclear power plant in Lithuania that would provide energy to all three countries has stalled.

In October, voters in Lithuania rejected the Rail Baltica plan in a non-binding referendum at the same time as a general election in which the Social Democratic party defeated the centre-right coalition. However, the president refused to form a government that included the Labour party, which was accused of electoral fraud. Rail industry experts note that while big infrastructure investments are typically made for a 30-year horizon, governments change far more frequently.

On both Rail Baltica and the power plant, the three governments are seeking to push ahead. Parts says the timetable foresees the end of preliminary work such as environmental studies by 2015, with construction beginning in 2017 at the earliest. The railway would then be open, on optimistic forecasts, by 2022 or 2023.

"In Tsarist Russia it took less time to build [a railway line] from St Petersburg to Tallinn, so it should be possible," Parts says.

However, the project is heavily dependent on EU funding through the proposed Connecting Europe facility. ➤

Off track: the Russian 1,520mm rail gauge is used in the Baltics, rather than the 1,435mm favoured elsewhere in Europe

PHOTO: DREAMSTIME

INFRASTRUCTURE
RAILWAYS

Parts says up to 85 per cent support is needed from the EU for the estimated €3bn cost, with the other 15 per cent coming from the cash-strapped Baltic governments and the private sector in each country.

But it is unclear how much money the European Commission will be able to allocate for Connecting Europe in its current budget discussions for 2014-20. It had proposed €50bn, but a draft in October had already cut this to €36bn, and the figure has remained under attack since.

Parts says all the Baltic states can do is to be prepared: "We are just focusing on doing our homework and being competitive. Rail Baltica is exactly the kind of project that connects Europe, not just improves existing connections."

Yet even if significant financial difficulties can be overcome, deeper questions about Rail Baltica remain.

> Even if financial difficulties can be overcome, questions remain

Stephen Archer, chief executive of Baltic Rail, an unrelated freight company that operates in the region and elsewhere in Europe, believes that while the rail project has merit, it is targeting the wrong market.

"Everyone who talks about Rail Baltica is talking about a passenger service [but] Baltic railways are essentially a freight-based network. I'm not convinced the passenger needs are there and I am not convinced the demographics of the region are there: there are not very many big cities."

Vision to reality: Juhan Parts is Estonia's minister in charge of the rail project (above); Tallinn would be the northern terminus (below)

However, Kaur Lass, chief executive at OÜ Head, an Estonian consultancy, says this is a classic chicken-and-egg situation. He points to the example of sea traffic between Helsinki and Tallinn, which was almost non-existent 25 years ago but which is substantial now.

"It is very easy to say we don't need a railway. If there is no infrastructure, there are no travellers. You're able to change the way people behave by having infrastructure in place," he says, arguing that a fast train connecting Tallinn to the southern Estonian city of Pärnu in less than an hour would allow workers to commute between the two.

Archer, however, insists that the focus should be more strongly on freight: "The potential opportunity of Rail Baltica is much more in the freight area, linking the production areas of Finland to central Europe.

"We are very keen to run services through to the Baltics. It is very difficult at the moment to compete with trucks and shipping."

Stubb sees the same logic, saying: "It could be a way of transporting our exports." Finnish industry, in particular the paper sector, is worried about an EU directive on sulphur emissions in maritime fuel that is likely to make sea freight more expensive.

Still, the symbolism of the project is what resonates more than anything. Archer, something of a sceptic, sums up the argument: "We do not have many pan-Baltic investment projects. [Rail Baltica] shows support and tries to link the Baltic countries with the centre of Europe.

"These are important issues, but they are geopolitical, not to do with a railway." ■

PHOTOS: DREAMSTIME; EPA

High-speed delay

Poland has put its ambitious €6.3bn high-speed rail project on ice as the country seeks private sector investors, writes Mark Odell

The Baltics states are not alone in trying to grapple with the problems associated with ambitious rail projects.

Poland has faced similar setbacks in its ambitions to bring its railroads into the 21st century. Further to its role in the Rail Baltica project, the Polish government had hoped to take a step beyond merely upgrading its extensive, but largely decrepit, rail network by building the country's first intercity high-speed line.

The project was mooted in 1990 but it was not until 2007 that the government of newly elected prime minister Donald Tusk put high-speed rail at the heart of its infrastructure agenda. The plan was to build a 450km, Y-shaped link from Warsaw to Lodz, Poznan and Wroclaw.

Fast track: the line from Warsaw to Chopin airport is the only modern rail link built in Poland in recent years

Trains would run up to 350kph, slashing journey times. In the south-west, the line would have transformed Wroclaw's links to the capital; poor rail and road connections mean the 330km trip takes more than five hours.

The cost of the project was put at 26bn zloty (€6.3bn) but when the financial crisis led to tighter budgets, officials had second thoughts; the cost would have eaten up almost all the rail funding Poland receives from the EU until the end of the decade.

Slawomir Nowak, the country's transport minister, announced the cancellation of the project a year ago, saying the priority was to upgrade the existing rail network.

Two-thirds of Poland's almost 20,000km of track are in "urgent need of investment", according to Danuta Dupieu, director of central Europe for Systra, a rail consultancy. Many lines cannot support speeds of more than 40kph.

After the collapse of communism, the Polish government's primary focus in surface transport infrastructure was the road system: railways were starved of much-needed investment.

The cancellation of the high-speed project, however, led to furious lobbying by the three cities due to be linked to Warsaw. The government has agreed to continue a feasibility study into the project, which is set to report in 2016.

Dupieu is optimistic the high-speed railway could become a reality but says the government is clear it will only happen if the private sector jointly finances construction.

"It would depend on the level of interest from private investors because one thing is certain, the Polish government cannot finance it alone," she says. ■

Seller's market

Vladimir Putin has pledged to roll back state ownership and open up Russia to investors, but there are some important exceptions, says **Isabel Gorst**

Immediately after being sworn in as head of state at a lavish ceremony in the Kremlin Grand Palace in May, Vladimir Putin set to work, signing a raft of decrees that put his policy agenda into law.

Buried in an order on "long-term state economic policy" was an instruction to redraft a sweeping privatisation plan launched in 2010 by Dmitry Medvedev, the outgoing president, which had been delayed by volatile markets and political infighting.

Putin's decree calling for the state to exit all companies in Russia's $1.86tn (€1.43tn) economy by 2016 seemed a welcome shot in the arm for his privatisation plan, but there were important exceptions. The state's vast natural resources and defence holdings, as well as so called "natural monopolies", were not included in the sell-off plan.

After ruling Russia in tandem for almost four years, the two men were swapping jobs, with Putin as president and Medvedev heading the government. On his last day as prime minister, Putin had named his ally Igor Sechin as head of Rosneftegaz, a holding company for the government's share in Rosneft, the state oil company, the natural gas monopoly Gazprom and various electricity producers.

> Resources and defence holdings are not included in the sell-off

When BP, the UK oil group, announced plans to sell its 50 per cent stake in TNK-BP, Russia's third-largest oil producer, Sechin was ready to pounce: Rosneft agreed to buy TNK-BP in a $56bn deal that will roll back private ownership of the Russian oil industry and put the state in control of more than 50 per cent of the country's oil output of 10.2m barrels a day. "The numbers are astounding," says Sergei Guriev, rector of the New Economic School in Moscow. "We will have another Gazprom in the oil sector."

For foreign investors, the decision to withdraw strategic sectors from privatisation lists is not a "game changer", says Dimitri Kryukov, chief investment officer of Verno Capital, a Moscow investment fund. "There was already an unofficial understanding that oil, gas and defence were off limits to foreigners, by and large," he says.

A bigger question is whether Russia will stand by plans for other privatisations at a time when global uncertainty is weighing on equity markets.

In an encouraging development, Sberbank, Russia's state savings bank, took advantage of a recent market rally to launch a secondary offering of 7.58 per cent of its stock, which raised $5.2bn, mainly on the London Stock Exchange. German Gref, Sberbank chief executive, said the sale should pave the way for more privatisations: "If they believe in us, they believe in Russia."

Unlike many Russian companies being lined up for privatisation, Sberbank has shed its reputation for poor corporate governance. Putin welcomed the sale, saying that, as an investment target, the bank was second only to Apple, the US computer group.

Plans are also afoot to sell minority stakes in VTB, Russia's second-biggest bank, Sovcomflot, the state shipping company, and Alrosa, a diamond producer. Other possible privatisations include Russian Railways.

Stock offer: German Gref oversaw the recent sale of shares in Sberbank, Russia's state savings bank

PHOTO: AFP

Not all investors are convinced. "We have had the same companies on the list for three years now. Is this Groundhog Day or is there something different this time?" says Peter Westin, chief economist at Aton, the Moscow-based investment bank.

Guriev, however, believes the privatisation programme, although demanding, will be fulfilled by the 2016 deadline set in Putin's inauguration day decree. "A lot of stuff has to be done, including the sale of all the banks," he says. "Do we believe this? We should. Putin cannot afford not to fulfil his promises."

Privatisation got a bad name in Russia during the infamous loans-for-shares scheme in the mid-1990s, when a small group of well-connected businessmen landed control of the crown jewels of Soviet industries for bargain prices. At the time, the Kremlin was struggling to pay government wages and avert economic collapse. But many ordinary Russians saw the transfer of the nation's best assets to a group of favoured insiders as daylight robbery.

As the Russian economy flourished on the back of high oil prices, a new generation of tycoons has sprung up with good Kremlin connections. Now there is concern that some of them might benefit from their proximity to power in a fresh round of privatisations – just as the previous group did in the mid-1990s.

Investors have raised questions about the rapid growth of Summa, a ports and logistics group that has built a portfolio of assets to take advantage of Russia's strategic location as a land bridge between China and Europe. The company is controlled by Ziyavudin Magomedov, the billionaire businessman who is on good terms with Arkady Dvorkovich, the deputy prime minister, and Nikolai Tokarev, president of the state oil pipeline monopoly, which is a co-owner with Summa of Russia's Novorossiysk sea port.

At a privatisation auction this May, Summa won a 50 per cent plus one share in the state-owned United Grain Company, and is aiming to win more state assets, including Transcontainer, a unit of Russian Railways that handles half of the country's container freight traffic. Summa says it has not benefited from connections with officials, and Dvorkovich says he has not helped the group.

Guriev says as long as privatisation auctions are competitive and transparently handled there is no risk of a repeat of the corruption allegations that accompanied the mid-1990s sell-off. Western banks have been hired by the government to supervise auctions and ensure fair play.

Investors are urging the government to bring more companies to the public markets rather than focus on auctions and private placements. "We need to see new companies coming to market," says Westin. This would boost liquidity and diversify the Russian stock market away from oil, and could provide a home for some of the capital that, amid a dearth of investment opportunities, is fleeing Russia at a rate of more than $80bn a year. ■

AUTO INDUSTRY
BULGARIA

PHOTO: AFP

Open to investors

A leading Chinese carmaker is using Bulgaria as an entry point to new markets, says **Kerin Hope**

Assembly line: the Voleex C10 is built by Litex Motors near Lovech

Barely four months after passing his driving test, George Todorov won a competition on Facebook to promote the Voleex C10 hatchback, a Chinese car assembled by Litex Motors in Bulgaria.

The Sofia student answered the question, "Why I should win a car", by posting a photoshopped picture of himself next to a Voleex on the social networking site, along with the message: "You don't often feel proud of being Bulgarian because of something that's manufactured here, so I'm grateful to Great Wall Motors for making it possible." The image was "liked" by more than 25,000 Facebook subscribers.

Great Wall, China's largest privately owned carmaker, has chosen Bulgaria as its test market for manufacturing in the EU, teaming up with Litex Commerce, a diversified holding group with interests in commodities trading, construction and the Lovech football team, in a €120m joint venture called Litex Motors.

In February, its plant, built on disused land near Lovech, began assembling the Voleex C10 from kits manufactured and painted in China. The plant employs 160 workers, mostly in their early 20s. Output topped 1,000 units in the first nine months of operations, according to Iliya Terziev, chief executive of Litex Motors.

"We are still at the beginning, but we are moving according to schedule," Terziev tells me from his office above the spacious showroom in the capital Sofia. The Voleex is among the top 10 sellers in Bulgaria in the small-car category, he adds.

The EU's poorest country offers labour costs comparable with China, a flat tax rate of 10 per cent and an underdeveloped ➤

AUTO INDUSTRY
BULGARIA

local market. Yet Great Wall has arrived in Bulgaria during a Europe-wide downturn that may test China's reliance on cheap prices to gain a foothold in EU markets.

"This is a bold venture... It is going to take two years to see if it can be successful," says Pavel Ezekiev, a partner in Neveq Capital Partners, an investment manager for two Sofia-based funds that are investing in eastern Europe.

Even when the Litex plant is operating at its full capacity of 50,000 cars a year, output will lag far behind western carmakers in central and eastern Europe. Boosted by big names such as Volkswagen and Kia Motors, Slovakia is set to produce more than 750,000 units this year, and the Czech Republic more than 600,000.

Great Wall is taking only a 10 per cent stake in Litex Motors. The rest of the company is owned by Grisha Ganchev and Tsvetan Vassilev, two influential Bulgarian oligarchs.

Bulgaria has a mixed record as a carmaker. Under communism, a state-owned Bulgarian company assembled the rugged Moskvich 408 from kits supplied by the Soviet Union. A short-lived joint venture between the UK's Rover and Daru Group, a private Bulgarian company, to produce the Rover Maestro in Sofia ended in 1996 after Daru was hit by cash-flow problems.

> 'There was one gap left in the regional map of carmakers – and we have filled it'

Bulgaria watched from the sidelines as Poland, Hungary, the Czech Republic and Slovakia attracted foreign carmakers seeking low-cost manufacturing sites in the new EU member states.

After Renault took over Dacia in Romania, and Fiat moved into Serbia, "there was one gap left in the regional map of carmakers – Bulgaria – and we have filled it", Terziev says.

Even though Great Wall is China's biggest producer of SUVs and pick-ups, it chose to launch its brand in Bulgaria with a low-budget city car. The Voleex C10, a small five-door hatchback, sells for 15,000 lev (€7,650), competing on price with similar models from Dacia and Citroën.

The Voleex C10 is already being exported to Macedonia as a more affordable alternative to the Fiat 500L, produced at the former Yugo plant in neighbouring Serbia. There are plans to open a dealership in Greece, where sales of Mercedes, BMW and Audi cars have plunged during the recession.

Great Wall will start making the more expensive Steed 5, a double-cab pick-up known in China as the Wingle, at Lovech next year. Domestic sales look promising as the pick-up is Bulgaria's most popular vehicle type, Terziev says. It will sell for about Lev25,000 (€12,760).

Next will be the Hover 3, the top-selling SUV in China, which is due to start production in 2013. To assuage concerns about reliability, all three Great Wall brands made in Bulgaria carry a five-year service guarantee.

Great Wall expects to set up a welding and paint shop at the Lovech plant as output expands. So far, it has limited locally sourced components for the Voleex C10 to batteries and engine lubricating oil. But there are plenty of Bulgarian automotive suppliers, mainly subsidiaries of foreign manufacturers. These produce hydraulic pumps, bearings, plastic components and other items for western carmakers, among them Volkswagen, Mercedes-Benz, Peugeot and Ford.

Borislav Stefanov, executive director of InvestBulgaria, the government agency for foreign direct investment, says: "The automotive sector has already attracted a fair amount of

Top seller: Iliya Terziev, chief executive of Litex Motors (above); Great Wall will sell pick-up trucks (below) in Bulgaria from next year

PHOTOS: NEW YORK TIMES/REDUX/EYEVINE; BLOOMBERG

foreign investment, and many suppliers are keen to have a domestic customer... We expect Great Wall to turn to local companies as it becomes more integrated with the Bulgarian market."

Terziev shrugs off the European car industry's woes, saying Litex is too small and too new to be affected. Output will reach 15,000 cars only in 2015, by which time, he predicts, Great Wall's brands can tap the growth of a recovering Europe.

Yet exports will be critical to reaching the break-even target of 10,000 units by 2014. With 7m people and an average monthly wage of less than €400, Bulgaria is one of the EU's smallest car markets.

Only 27,000 new cars were sold in Bulgaria in 2011, compared with more than 250,000 second-hand imports, mainly of Mercedes and BMW cars, which are still considered status symbols even if the models are outdated by northern European standards.

The country's economy is forecast to grow by about 2 per cent next year, but after several years of near-flat output, Bulgarian consumers remain cautious about spending on big-ticket items such as a new car.

Some observers believe Great Wall may be able to build market share faster in parts of the west Balkans, which have escaped the worst effects of the downturn thanks to their large informal economies.

Montenegro, Bosnia-Herzegovina, Albania and Kosovo all have an emerging aspirational middle class. Ezekiev says: "Look around the south and west Balkans and there are up to 20m people who you would call low-income middle class. This could be the export market Great Wall is looking for." ■

Cross-border investment: Coca-Cola Hellenic, which has invested €300m in Bulgaria, recently opened a back office in the country

Standing by the neighbours

Greece has largely kept faith in Bulgarian investments

Fears that some of Greece's largest companies would leave neighbouring Bulgaria because of dire economic problems at home are easing, according to Stamatis Theodoropoulos, chief executive of Chipita Bulgaria, a manufacturer of flour-based snacks and chocolate confectionery products.

"Things were tough in 2010 and 2011 when Bulgaria, too, was hit by recession. But this year has seen the start of a turnround, and growth prospects here are positive," says Theodoropoulos, who also serves as chairman of the Hellenic Business Council in Bulgaria.

About 160 medium-sized and large Greek companies have set up Bulgarian subsidiaries, attracted by lower wage costs, a 10 per cent corporate tax rate, and a stable currency pinned to the euro. Several thousand small Greek companies are also involved in cross-border trading.

Five Athens-based banks control about 30 per cent of assets in Bulgaria's banking sector.

About €5bn of fresh capital will be allocated to Greek bank subsidiaries across the Balkans when Greece receives its next €34bn aid payment from international lenders. "This cash injection represents a long-term commitment to the region on our part," says an official at Greece's central bank.

A few Greek companies have even expanded their Bulgarian operation during the crisis. Coca-Cola Hellenic, the Coke franchise holder for 28 countries, last year set up a 160-strong human resources and finance back office in Sofia. Over the past two decades the company has invested roughly €300m in Bulgaria – about 10 per cent of total Greek investment in the country.

Sidenor, a Greek steel producer, is upgrading Stomana Industry, a Bulgarian steel minimill acquired in a post-privatisation sale, thanks to a $25m loan from the International Finance Corporation, the World Bank's investment banking arm.

Yet several smaller companies that relied on funding from Athens had to pull out as the Greek crisis deepened. "They were not well established in the Bulgarian market, and the parent groups were too squeezed to provide more financing," Theodoropoulos says. ■ **KH**

Vintage performance

Thanks to investment and a focus on quality, eastern European wines are now much in demand, says **Feargus O'Sullivan**

PHOTO: EPA

Hungary work: grape harvest in the Tokaj region

On a warm autumn afternoon in Tokaj, Laszlo Kalocsai waits patiently for his grapes to turn mouldy. On the edge of the Carpathian mountains, the best wines are only possible once the fog-borne fungus *Botrytis cinerea* has risen from the wetlands beneath the vineyards.

The fungus attacks the fruit on the vine, leaving each discoloured grape with barely a teaspoonful of intensely flavoured, sugary juice inside.

Without this so-called "noble rot", Kalocsai explains, his Chateau Dereszla winery, one of the finest in Hungary, cannot turn the grapes into Aszu, a rich, amber dessert wine once a favourite of Beethoven and Queen Victoria. Even with the right conditions, producing the wine takes skill, patience and substantial manpower.

With Tokaj's wine tradition dating back to the Middle Ages, Kalocsai and his fellow producers are hardly new to the game. Yet while their heritage is long, the winemakers of Tokaj still take pains to keep up with the times.

"In the past, wines from this region tended to be very oxidised, with darker colour and flavours of bread and caramel creeping in," Kalocsai explains.

"Now we take care to preserve the first fruity flavours of the wine, which makes them much more attractive to a western market. We have also reduced the length of time we mature our wines in oak barriques."

These efforts have paid off, with Chateau Dereszla wines selling well in the US, Scandinavia, and even the hard-to-please French market. The winery gained four silver medals in this year's Decanter World Wine Awards. While two of the medals were for the traditional Aszu wines, Chateau Dereszla also won plaudits for Dereszla Furmint 2011 and Dereszla Tokaji Kabar 2010, which are both made in a fresher, more contemporary style.

Sampling the chateau's collection in one of their centuries-old cellars – the exterior wall of which boasts a window that was pierced by a cannonball during Hungary's 1849 revolution – the wines range from the lean and basic to the complex and sophisticated, with flavours variously suggesting white blossom, peaches, melon and, in one especially off-beat example, smoked chilli peppers.

This sophistication is a far cry from the traditional view of eastern European wines as cheap and somewhat rough. Often perceived as something that might be emptied into a punch bowl rather than served by the glass to guests, the region's wines have long remained a foreign country to most oenophiles.

Yet drinkers' perceptions lag behind the times. Eastern European wines have improved greatly over the past two decades, and its vineyards now produce interesting, well-priced bottles whose qualities can easily surpass those of the ubiquitous Australian and South American megabrands sold in supermarkets, as well as rare and expensive bottles such as Hungary's Úri Borok Eszencia (see panel).

Hungary and Slovenia each won more than 50 medals in ➤

the Decanter World Wine Awards, while two Romanian reds were recommended in the US's highly selective Ultimate Wine Challenge. Consumer interest is following this critical enthusiasm – in the first quarter of 2012, Bulgarian wine exports were up almost 13 per cent year-on-year. Hungarian export levels have fluctuated in recent years but, if gains continue, exports for 2012 are set to rise 2.4 per cent year-on-year.

While eastern Europe still produces its fair share of cheap plonk, its better winemakers have sought to lower crop yields to improve flavours. Dull but heavily cropping grape varieties have been ditched, with superior, though harder-to-grow, vine types taking their place. From the former East Germany to Bulgaria, winemaking processes such as filtering and storing have been made more hygienic. Crucial investment has also arrived, with money from both private investors and the EU flowing in, helping to replace moribund equipment and tighten regulation.

Yet the rise in quality has run parallel to a sharp fall in production. Declining sales to the Russian market in the 1990s, as well as the current economic malaise affecting the eurozone, have contributed to the loss of much of eastern Europe's vineyard area. Despite a good year in 2011, Hungary's wine production has shrunk by about 17 per cent over the past five harvests, while Bulgaria's total vineyard area has roughly halved in the past decade.

While this has meant the end for vineyards that have, in some cases, been in existence for hundreds of years, it has also had the perverse effect of improving quality. The bulk wine market has shrunk; wine drinkers today expect higher quality, and are prepared to pay for it. The superior producers have thus been able to weather the storm.

Taste test: a new generation of eastern European producers is targeting the western European market

According to Gareth Lawrence, an eastern European wine expert and lecturer at the WSET London Wine School, this combination of reform and adversity has helped some countries reinvent themselves as quality wine producers, while others have struggled to rebrand.

> 'Tokaj and its wines are mentioned in Hungary's national anthem'

"Hungary has been particularly good at getting foreign investment, so much so that there is now a degree of resentment of the wine industry being owned by foreigners," he says. "Slovenia and Croatia have also made great strides, perhaps because both regard themselves as western-looking.

"In Bulgaria, by contrast, as a foreigner you could not own any land within the country until quite recently, which inevitably halted the pace of international wine investment there."

Foreign interest in Hungary's wine industry has provided investment and connections. Once run by the region's sole state winery, Chateau Dereszla's Tokaj vineyards were bought in 1992 by the French D'Aulan family, who owned Piper Heidsieck Champagne until 1998, and who have vineyards as far away as Argentina. The vineyards on the hillside next to Chateau Dereszla have been bought by a Chinese-American consortium.

In Hungary, many of the improvements stem from the country's privatisation efforts in the 1990s, which encouraged entrepreneurship.

Kalocsai explains that when communist rule ended, vineyard owners whose land had been confiscated were given the opportunity to buy up portions of the

PHOTO: NEW YORK TIMES/REDUX/EYEVINE

state's vineyards. "This created a new level of committed, small and medium-sized producers," he says, "something which happened much more slowly in other eastern European countries, where state wineries were privatised as large, intact enterprises."

Yet the wine market in western Europe remains highly competitive and increasingly mature. To counter this, eastern European winemakers are looking to re-enter the improving Russian market, where sales of wine are rising steadily. The value of retail wine sales in Russia rose by more than $2bn (€1.5bn) in the past five years to $8bn. "In looking for new consumers for eastern European wines, there has definitely been a movement eastwards to emerging markets, with a particular focus on Russia's growing middle class," says Lawrence.

Despite this, the vast majority of eastern European wine is still consumed by the domestic market. Romania, for example, exports just 3 per cent of its wine production, and outward-looking Slovenia exports only 7 per cent.

Nonetheless, as international recognition for quality shows, the best eastern European wine regions are successfully rebranding, as winemakers in neighbouring Austria had to, following a wine adulteration scandal in the 1980s. The resultant collapse of the country's wine industry allowed Austria's producers to regroup and shift from bulk to boutique production, transforming their reputation.

Back at Chateau Dereszla, Kalocsai is preparing to harvest his grapes. "Tokaj and its wines are so important to Hungarian identity that the region is mentioned in the national anthem," he points out. "Making sure our wines keep their quality also means we are preserving our peoples' patrimony." ■

From drinkable budget bottles to collectors' items

Six of the best from eastern Europe's top vineyards

Calusari Pinot Noir, 2011, Romania
This superb-value wine is not the most complex Pinot Noir on the market, but it still has attractive cherry, violet and cinnamon flavours, medium body and a fine, smooth finish. The wine, which retails for less than £7 (€8.60) in the UK, shows that it is possible to produce good Pinot Noir on a budget.

Ivo Varbanov Mavrud Merlot Wandering Shadows, 2009, Bulgaria
Little known beyond its home country, Mavrud is an intense, low-yielding red variety with plenty of tannic grip. Its smoky, toasted flavours are softened with a smaller dose of red fruit provided by the Merlot grape, before being mellowed and deepened by ageing in new oak.

Puklavec & Friends Sauvignon Blanc, 2011, Slovenia (left)
Produced by one of the few Slovenian wine brands to break through in the UK, this classic Sauvignon Blanc has the crisp gooseberry, elderflower and grapefruit notes typical of the variety. The wine stands up well against some of the similarly priced New Zealand Sauvignon Blancs that are extremely popular in Britain.

Zlatan Otok Zlatan Posip, 2010, Croatia
A regional trophy winner at this year's Decanter World Wine Awards, this excellent white wine made from a little-known local grape variety mixes citrus fruit with wild herb and flower notes, softened by flavours of melon and fig.

Royal Tokaji Mezes Maly, 6 Puttonyos, 2005, Hungary (right)
From one of Tokaji's finest vineyards, this rare and almost honeylike dessert wine – the "6 puttonyos" in the name refer to the number of measures of super-sweet botrytised grapes that are added – offers extremely long flavours of clementine, marmalade, apricot and chamomile, balanced with a sharp acidity.

Úri Borok Eszencia, 2000, Hungary
This extremely rare dessert wine, which retails for about £700 per half bottle in the UK, is made from the juices that run naturally off shrivelled, botrytised grapes as they sit in the harvesting bucket. Viscous, orange-coloured and heavy with flavours of marmalade, pears and sugarcane, this scarcely alcoholic wine (it is only 2 per cent alcohol by volume) is too sweet to drink in large quantities, but still remains a luxury coveted by collectors for its unrivalled levels of concentration. ■ **FO'S**

Economy break

The record number of holidaymakers flocking to Croatia this year are a welcome boost to the country's finances and an inspiration for its neighbours, reports **Andrew MacDowall**

With its brilliant white walls and lapis-lazuli dome, Villa Sheherezade in Dubrovnik is an eyecatching sight on a steep, forested hillside above the Adriatic Sea.

The lovingly restored 1920s villa, surrounded by lush gardens, has played host to rich and famous international guests, including actor Kevin Spacey, Prince Saud bin Abdul Mohsin of Saudi Arabia and Viktor Vekselberg, the Russian billionaire who rented the property for six months, reportedly paying €750,000 for the privilege. With a bill like that, Vekselberg may well have retreated to the striking blue dome, which houses a meditation room.

The opulent villa's rates are beyond the means of most visitors but its appeal to the super-rich is a sign of the revival of Croatia's tourism fortunes. Less than two decades after the end of its bloody war of independence, Croatia's tourism sector is flourishing.

Almost 10m visitors came to Croatia from January to August, a rise of more than 4 per cent on the same period in 2011, says Veljko Ostojic, the country's tourism minister. "This is the best tourist season in Croatia's history," he says.

Ostojic expects tourism income to rise 3-5 per cent this year, to more than €7bn.

While adventurous visitors had been coming to the Adriatic coast for years, the Croatian tourism industry really began to emerge in the 1960s, according to Leila Kresic-Juric, director of the tourism section of the Croatian Chamber of Economy.

As the most liberal – and least pro-Soviet – of the communist countries in eastern Europe, Yugoslavia adopted an open policy towards tourism, enticing visitors from western Europe with package holidays to the Croatian and Slovenian coasts.

Big resort hotels were built and by the mid-1980s tourism was booming, with Croatia alone receiving about 10m visitors a year.

But at this time national tensions within Yugoslavia were increasing. Croatians' desire to keep more of the tourism revenues was a bone of contention, if not the most important, in the disputes between the Yugoslav republics. With the outbreak of war in 1991, tourist numbers plunged, although the country still welcomed more than 2m visitors a year until the war ended in 1995.

> Revenue growth, diversification and increasing value are priorities

The recovery began almost as soon as the guns fell silent, with tourist numbers climbing steadily year on year to top 11m in 2011.

Both the government and private sector are anxious that Croatia should capitalise fully on its success. Further revenue growth, diversification and increasing value are priorities, not least as tourism is a rare bright spot in an economy that has failed to register meaningful growth since 2008.

According to Tihomir Nikolas, a board member at Riviera Adria, a holiday company, Croatia's core customers are families from western European countries including Germany.

Foremost attraction: Dubrovnik is known as the 'pearl of the Adriatic'

PHOTO: CORBIS

As Kresic-Juric notes, Croatia combines its geographical advantages – a long and beautiful coastline, more than 1,000 islands and a warm Mediterranean climate – with relatively low costs, although visitors to Dubrovnik might quibble with the suggestion that the country is a budget destination.

Sun and sea remain the main draws, not least on the islands. Krk, the largest, is a centre for package tourism; Hvar has acquired a reputation for its nightlife and luxury accommodation; while rocky, arid Pag is developing a niche in gastronomy, partly thanks to its salty, herby cheese. Nautical tourism is a growing interest for the sailing fraternity, while the string of Venetian-influenced towns along the coast is another draw.

Most notable is Dubrovnik, the "pearl of the Adriatic", hemmed in by its famous walls and packed with churches, palaces and atmospheric narrow streets. The city, which suffered three months of bombardment during the war, is Croatia's foremost tourist town, attracting visitors from around the world.

"Anyone who has visited Dubrovnik can see Croatia already rivals the best holiday destinations in Spain and France," says Kresic-Juric.

Croatia's other coastal draws include Split, where the palace of Roman emperor Diocletian is at the heart of the vibrant city; Trogir, with its beautiful, carved cathedral portico; Zadar, where Roman ruins stand within a picturesque medieval town; and Rovinj, reminiscent of Italy, with its stunning hilltop setting above the sea on the Istrian Peninsula.

Places like these – as well as the elegant capital, Zagreb – are central to Croatia's drive to build the cultural tourism ➤

segment, one of a number of niches in which industry leaders perceive particular competitive advantages. Others include adventure tourism, capitalising on Croatia's mountainous and unspoiled landscape, medical tourism and gastronomy.

These appeal to well-heeled tourists and the hope is that developing such niches can help Croatia increase the sector's value-added element.

Achieving this will require greater private investment in accommodation, resorts, infrastructure and attractions. The bulk of input currently comes from local investors such as Riviera Adria and Maistra, a hotel and resort operator owned by Adris Group, Croatia's largest tobacco company.

Significant foreign investors include EPIC, the Austrian owner of Valamar Group, which runs hotels and resorts along the coast, and Luksic Group, a Chilean outfit founded by Andronico Luksic, the late Croatian emigrant.

Several large international hotel chains are present. Hilton brands the famous Hotel Imperial in Dubrovnik, while Sheraton has hotels in Zagreb and Split. But there is still a feeling that more could be done to attract foreign investment, with improvements in the business climate seen as vital if the country is to realise its gains.

"The most important thing the government can do is to speed up investment in tourism, but the global [financial] crisis has hindered investors' optimism," says Boris Suljic, owner of the Boskinac Hotel and winery on Pag."This is especially true in the tourism sector, where investment is returning to normal somewhat slowly."

Nightlife: a record number of tourists are expected to visit Croatia this year

He adds: "The state is on the right track and aware that without investment there can be no economic growth. We want to believe that within the next year the government will bring forth better, more efficient laws that will speed up processes to encourage domestic as well as foreign investment in Croatian tourism."

> 'The most important thing for the government to do is to speed up investment'

Suljic is confident Croatia's EU accession, which is expected in July, will help catalyse investment, with membership helping to underline improvements in Croatia's political, economic and legal stability.

Croatia is in the fortunate position of having the advantage of cultural and natural attractions to develop high-end tourism. A few islands and patches of coast aside, it has managed to avoid a race for the mass market.

On the other side of the Balkan peninsula, Romania and Bulgaria – beautiful and fascinating countries – have largely focused on low-cost beach (and in Bulgaria, ski) tourism. As a result, stretches of the Black Sea coast are blighted by high-rise hotels and both countries are struggling to break out of the perception that they are destinations for cheap package holidays.

Bosnia-Herzegovina, Serbia and Macedonia, all with substantial tourism potential, also lag well behind Croatia, although the former Yugoslav neighbours to the north and south, Slovenia and Montenegro, have done well.

Slovenia has carved out a niche as an adventure tourism destination, as well as benefiting from Ljubljana's improving air connections to western Europe. Montenegro is home to the world's fastest-growing tourism industry, according to the World Tourism and Travel Council, an industry body.

Like Croatia, Montenegro benefits from a coastline studded with attractive towns, as well as a mountainous interior. Long a popular destination for Serbs (particularly since the war, when many have felt unwelcome in Croatia), Montenegro's appeal has widened in recent years, with western Europeans and Russians flocking to its coast; investment in tourism property has become an important economic driver.

Porto Montenegro, the country's flagship luxury resort – owned by Peter Munk, the Canadian gold magnate – has been touted as a model for tourism development in the country and beyond.

With the region's wider economic landscape still bleak, tourism in Croatia and Montenegro is a welcome eastern European success story. ■

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