INVESTING IN Central & Eastern Europe

FINANCIAL TIMES **SPECIAL REPORT** | Tuesday November 30 2010

China calling
The region is a stepping stone to western markets, but some local companies have cried foul
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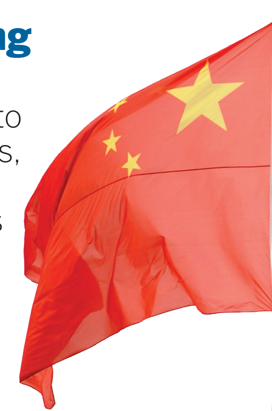

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Plans diverge as region makes patchy recovery

Nations are tackling the fall-out from the economic crisis and strategies for growth in their own way, writes **Jan Cienski**

Most emerging markets came through the global economic crisis largely unscathed – but one stark exception was central and eastern Europe. Most of the region was hit hard in 2009, and its recovery is still lagging behind emerging markets elsewhere.

The downturn exposed some of the imbalances that had been overlooked during the boom that followed the region's entry into the European Union. Now governments from the Baltics to the Balkans are scrambling to repair their public finances in case another aftershock of the economic crisis hits.

"This region is emerging Europe. The emerging part is good, but the Europe one is bad," says Mark Allen, the IMF's senior representative for the Baltics and central Europe.

He notes that the region shares some characteristics with other emerging markets in Latin America and Asia, such as a cheaper workforce, but also some of the more negative aspects of developed Europe, including high levels of social spending and relatively low savings rates.

The challenge for governments is going to be to accentuate the developing part of their economies, which will spur growth, while trimming welfare benefits and red tape that stifles business – all without provoking the kinds of street protests seen in Greece and France this year.

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One of the casualties of the crisis was the concept of central Europe itself. It has always been a shorthand expression covering the countries that used to form the western fringe of the Soviet Empire. However, the countries of the region are becoming increasingly diverse.

Last year, as the crisis hit, the three Baltic countries suffered double-digit economic contractions, while Poland eked out a 1.7 per cent GDP increase. The Czechs and Slovaks, with very open, export-dependent economies, suffered recessions of more than 4 per cent.

Hungary had to turn to the IMF and the EU for a $25bn aid package and saw an economic contraction of 6.3 per cent in 2009. Romania did even worse, with a recession of 7.1 per cent.

Outside perceptions have not always caught up with the widely diverging responses to the crisis. "The broader investment community is unaware of how well Poland has done," says Ben Habib, chief executive of First Property Group, a Warsaw-based real estate investor. "When I say I'm in Poland, I get a look of sympathy – they don't realise what it's like here."

Central Europe has come out of the crisis divided into three parts. The central core are the members of the Visegrad regional grouping of Poland, the Czech Republic and Slovakia, with fairly sound public finances, strong banking sectors and decent growth prospects.

Leaving the past behind: old and new come together in the centre of Warsaw, Poland's capital — Alamy

To the north are the Baltics, which suffered a severe downturn and are now on a painful path of recovery. In the south are the troubled Balkan countries, with Hungary, also a Visegrad member, straddling between the core of central Europe and the Balkans.

"Hungary is in a halfway house," says Matteo Napolitano of the Economist Intelligence Unit. "It shares some positive characteristics with the other Visegrad countries in having a solid export sector, so it has been able to tap into the Germany-led recovery. The negative side is the fiscal imbalances and all the issues relating to excessive lending in foreign currencies."

The crisis provoked a political response across the region, as elections over the past year showed a noticeable shift to the right; populists lost power and were replaced by belt-tighteners calling for cuts and austerity.

"There is a new challenge to face: not only the effects of the economic crisis but also how to restart our economy," says Iveta Radicova, the new Slovak prime minister.

The plan is not only to cut one-seventh off the state budget next year by slashing €970m in spending and increasing taxes by €730m, but also to tackle pension and healthcare reform that would again make Slovakia one of the continent's fastest growing economies – a task neglected by the previous populist government of Robert Fico.

"The boom of 2000-2008 will never be repeated, but the Slovak economy does have the potential for growth of 6-7 per cent a year," says Ivan Miklos, the finance minister.

The new Czech government of premier Petr Necas is taking similar steps, with the aim of reducing the budget deficit from 5.3 per cent of GDP this year to below 3 per cent in 2013 and to balance it by 2016.

"If we hesitate in taking these steps, then in several years much more drastic measures would be needed," he says.

Poland's centre-right Civic Platform party, which consolidated its control of the country by winning this summer's presidential elections, is being much more cautious about root-and-branch reforms than its southern neighbours. Despite running a deficit this year of 7.9 per cent, and with public debt perilously close to the 55 per cent legal threshold which, if crossed,

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New governments dispense tough medicine for voters

Politics

Jan Cienski finds that populism of the recent past has come with a price

Tough times have a way of concentrating the mind – which is why much of central Europe has turned away from the populism and easy promises of the recent past to a more austere centre-right conservatism that promotes the virtues of cutting spending and tightening belts.

But with the notable exception of Latvia, voters in the rest of the region are already showing some signs of skittishness at the medicine being doled out to them by their new governments.

Sitting in her Bratislava office, Iveta Radicova, the new prime minister of Slovakia, is a good example of the new breed of central European politician. Leaning forward in her chair, she spells out how her government plans to slash one-seventh of the state budget in order to bring the deficit under control.

A symbolic part includes multiplying the annual deficit – in this case almost 8 per cent of GDP – by three, and imposing that level of pay reduction on 2,600 senior officials, including the president.

That means that next year, Mrs Radicova can look forward to a 24 per cent salary cut. "Those who are responsible for the deficit will have to pay," she says.

A large part of the blame for Slovakia's current fiscal situation lies with Robert Fico, Mrs Radicova's populist predecessor, who was swept to power in 2006 on a wave of voter exhaustion with the often painful economic reforms that had been a hallmark of the previous centre-right government.

Mr Fico's 2006 victory was part of a wider trend that saw populists win power across the region.

Central Europe had been on its best behaviour for the decade leading up to entry into the European Union in 2004. But after achieving that goal, and with the global economy booming, voters turned from reformers to parties that promised to ease up on talk of reform.

In 2005, the ex-communist left was ousted in Poland, discredited by a corruption scandal. The right wing populists of the Law and Justice party, founded by the Kaczynski twins – Lech and Jaroslaw – embarked on an expansionary economic policy.

They combined that with an obsessive – and ultimately failed – hunt for a network of spies, criminals, and corrupt business leaders that the twins felt were running Poland from behind the scenes.

The Kaczynskis' domestic policies were leavened with a return to nationalism – as Jaroslaw, the prime minister, and Lech, the president, criticised Germany and Russia, Poland's historic enemies. In much the same way, Mr Fico and his nationalist coalition allies built up support by criticising Slovakia's large Hungarian minority.

Law and Justice's excesses cost it the 2007 election, which brought the centrist Civic Platform party to power. Instead of berating Germans or Russians, Donald Tusk, the prime minister, promised in his first interview with the Financial Times to take a "machete" to the bureaucracy that entwines Polish businesses – a goal that has not yet been achieved.

The caution over slashing red tape extends to fiscal policy, where Poland has been much more timid about cutting spending than its neighbours, as Mr Tusk tries to keep voters from bolting before next year's parliamentary elections.

> Central Europe had been on its best behaviour for the decade leading up to entry into the European Union

Lech Kaczynski was killed this spring in the crash of a Polish government airliner, and his twin narrowly failed to win election as president this summer. Instead, Poles turned to the somewhat earnest Bronislaw Komorowski, a close ally of Mr Tusk.

Competence is also the hallmark of the new Czech government of Petr Necas, which took power this year after a one-year interregnum following the collapse of the administration headed by Mirek Topolanek.

The bookish Mr Necas comes from the same centre-right Civic Democratic party as Mr Topolanek, but exudes none of the raffish charm of his predecessor, once photographed naked while visiting the Sardinian villa of Silvio Berlusconi, the scandal-tainted Italian prime minister.

Mr Necas has the reputation of being one of the cleanest men in Czech politics – and says he is determined to stamp out corruption. "It is public enemy number one," he says.

However his austerity programme – the ambitious idea is to balance the budget by 2016 – is already causing some cold feet among voters, who recently returned control of the upper chamber senate to the centre-left Social Democrats.

"This is a complication but not an obstacle to reforms," says Mr Necas.

Some voters have proved to be more resilient in the face of necessary austerity, with Latvians returning a three-party governing coalition to power in October elections with an increased majority. But otherwise the taste for austerity has limits.

Hungary, as always something of a regional outlier, also turned right this year, electing Viktor Orban and his Fidesz party.

However, in contrast to other centre-right leaders in the region, Mr Orban has mixed a lot more populism into his promises, provoking a fight with the International Monetary Fund and implementing controversial taxes to keep the deficit and debt from spinning out of control.

That stance was rewarded in local elections in October, which sealed Fidesz's control of Hungary.

And in November, Poland's Civic Platform also did well, on a programme dedicated to no radical reforms.

Changing course: Slovakia's Iveta Radicova — Getty Images

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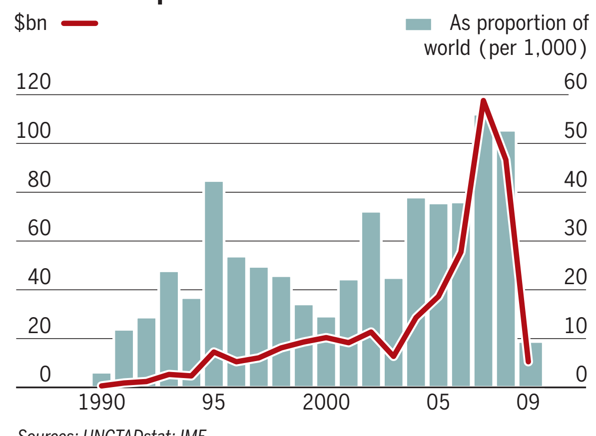
Exports to Germany help relieve crisis

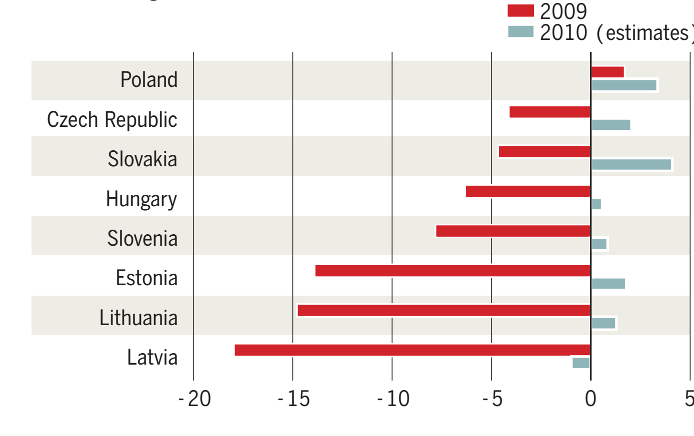
Economy

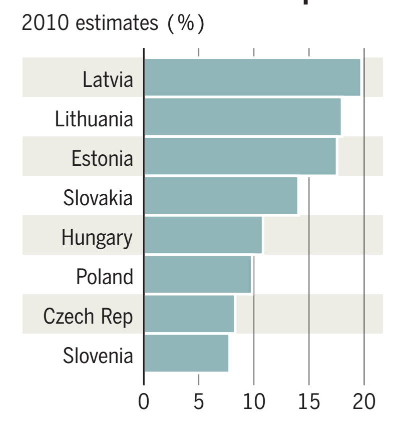
Jan Cienski and **Chris Bryant** find most nations have returned to growth but imbalances in public finances are a problem

The Charles Bridge, Prague

Photo: Headline Photo Agency







Ivan Miklos, the Slovak finance minister, has little doubt as to why his small and open country will notch up one of the European Union's fastest economic expansions – 4.1 per cent – this year.

"It's thanks in large part to exports to Germany," he says.

The story is the same for much of the rest of the region, which has been pulled from last year's recession – one that only Poland managed to avoid, – in no small part because of Germany's export-fuelled economic recovery.

Czech, Slovak, Polish and Hungarian factories, especially those producing for the car industry *(see article below)*, are increasingly part of Germany's supply chain.

In the first nine months of this year, the three main car factories in the Czech Republic have seen production jump 13 per cent – and data are similar across the region.

That, combined with a revival in domestic demand, means most of central Europe will have a decent 2010. The World Bank estimates that central Europe's EU members will grow by an average 1.8 per cent this year, followed by 3.2 per cent in 2011, with only Latvia and Romania continuing to suffer economic contractions, while Poland will rival Slovakia for the region's fastest growth.

The crisis showed that, despite its common communist past, central Europe is increasingly diverse.

The three Baltic countries suffered severe double-digit recessions, while Poland, the region's largest economy, grew by 1.7 per cent. The Czech Republic and Slovakia have small and very open economies, and are no longer developing countries.

To the south, Hungary's hostility to the International Monetary Fund and exotic approach to economic reforms marks it as an outlier, while Romania struggles to return to economic growth.

One risk to growth comes if Germany's expansion slows. "The region is heavily dependent on recovery in Europe and particularly Germany," says Mark Allen, the IMF's senior representative for the Baltics and central Europe.

Another pressing problem is public finances. Imbalances were exacerbated by the crisis, and now most nations are implementing reforms of varying severity, although there is a danger of spending cuts driving them back into recession.

Romania is the economic laggard of the region owing to the impact of government austerity measures, which include a 25 per cent cut in public sector wages, a 15 per cent reduction in benefits and a 5 percentage point increase in value added tax.

As a result, the economy is expected to contract by some 2 per cent in 2010. Although growth is expected to return next year, it will do so at a modest rate of about 1.5 per cent.

"It doesn't signify a real recovery and won't be associated with increasing employment or purchasing power," says Liviu Voinea, a Romanian economist.

A superficial reading of Hungarian fundamentals would suggest that it has managed to stage a solid recovery.

Growth of at least 1 per cent is expected this year, which should accelerate to about 2.5 per cent in 2011. In 2010 it will record a current account surplus for the second year in a row and its budget deficit is projected in 2011 to fall below the Maastricht target of 3 per cent.

"On the face of it, it looks quite constructive. But the problem is how they achieve this on the fiscal side," says Christian Keller at Barclays Capital.

In order to meet its deficit goals, Budapest is relying on crisis taxes levied on the financial, retail, energy and telecoms sectors, as well as a temporary halt in state transfers to the private pension system.

With by far the highest public debt-to-GDP ratio in the region, a large stock of foreign-currency loans and no IMF safety-net (after the new government chose not to renew it), Hungary also remains vulnerable to renewed financial market turbulence.

North of Hungary, the picture starts to look a lot better.

Despite a contraction of 4.1 per cent last year, the Czech Republic came through with a rock-solid banking system and is growing again, while its public finances are sounder than those of many euro members.

The new centre-right government is trying to cut the budget deficit to 4.6 per cent of GDP this year, after hitting 5.3 per cent this year.

To do so, the government is cutting public sector wages by 10 per cent and reducing some social payments, provoking large demonstrations in central Prague.

The eventual goal is to reach a deficit of 3 per cent in 2013, and a balanced budget by 2016. During the crisis, public debt has jumped from 27 per cent of GDP in 2008 to 40 per cent this year – which is far below the levels seen in troubled eurozone countries such as Greece.

"We have prepared an austere budget for 2011," says Petr Necas, the new Czech prime minister.

> Romania is the economic laggard of the region, owing to the impact of the government's austerity measures

Similar steps are being taken in Slovakia, which was hit by a steep fall in exports last year. In an attempt to reduce the 8 per cent budget deficit to 4.9 per cent next year, Iveta Radicova, the new prime minister, is cutting spending by €970m – one-seventh of the state budget – while increasing revenues by €730m.

"We are in a really deep economic and financial crisis," she says.

As a member of the eurozone since last year, Slovakia has been keen to avoid the fate of the common currency's weaker members by taking decisive action now.

Mrs Radicova's radicalism stands in stark contrast to Poland's much more cautious approach. Warsaw is putting off sweeping steps at least until next year's parliamentary elections, when the ruling centre-right Civic Platform party is expected to win another four-year term.

Poland's situation is more perilous than its southern neighbours. The deficit is expected to come to 7.9 per cent of GDP this year, but the looming problem is its rising public debt, which is brushing up against a legal threshold of 55 per cent of GDP that, if crossed, requires painful spending cuts.

Although some independent economists worry that spending is unsustainably high, international markets still see Poland as a good risk, and are keen to buy up Polish government debt.

"Poland does need to reduce its debt, but I think it is choosing the right path," says Mr Allen.

Manufacturers in a drive forward at expense of west

Motor industry

Smaller cars and scrappage schemes have helped the sector, reports **Nicholas Watson**

In September, Romania's Dacia celebrated the millionth Logan car to roll off the assembly line since it started up in 2004.

The feat highlights how emerging Europe's car industry not only came through the credit crisis in remarkably good shape but is expected to benefit at the expense of the car industry farther west.

The Logan became one of the more ironic symbols of the crisis. Bought by Renault in the late 1990s, Dacia was restructured to produce this bulky-looking saloon car. With its virtues of affordability and reliability, the Logan was tailored specifically for consumers in developing markets such as those in central and eastern Europe (CEE).

However, Germany ended up as the Logan's largest market in 2009, as sales there surged more than threefold. It was an unintended beneficiary of the crisis stimulus plan to offer owners of cars more than nine years old €2,500 to junk their bangers and buy new, environmentally friendlier, wheels.

Rather than fork out for a new Mercedes, BMW or Audi, many German consumers opted for the bargain €7,500 Logan, using the cash-for-clunkers programme to get a 33 per cent reduction.

Dacia was a clear winner from these schemes, but it was not the only one. Overall, the car industry in eastern Europe did not suffer as badly as that in western Europe. According to the International Organisation of Motor Vehicle Manufacturers, eastern Europe produced 7.7 per cent fewer vehicles in 2009 than 2008, but this fall was a lot less than the 19.5 per cent decline suffered in western Europe.

This is mainly because the region primarily builds smaller cars such as the Fiat Panda in Poland and the Toyota Aygo in the Czech Republic – which performed better in the crisis because they are cheaper and the scrap incentives were more relevant, given the lower pollution emissions of smaller cars.

"The scrappage schemes really favoured smaller vehicles – Skoda sold about 100,000 units of its Fabia in the German market alone, which means that in 2009 one in seven Skodas sold was a Fabia in Germany," says Tim Urquhart, auto analyst at IHS Automotive.

In the short term, therefore, some predict the region's car industry could be hit disproportionately hard from the phasing out of these scrappage schemes – with output declining slightly when it might otherwise have been expected to keep rising.

IHS Automotive predicts car production in the Czech Republic, Hungary, Poland and Slovakia will fall from 2.532m units this year to 2.525m in 2011, and then to 2.494m units in 2012.

Over the longer term, though, eastern Europe is expected to continue expanding its share of Europe's overall car production. According to UniCredit, the CEE region's share of total European production jumped from 9 per cent in 1999 to 24 per cent in 2009.

Surprisingly, given the drop in vehicle demand and the industry's overcapacity, there have been no plant closures anywhere in Europe to date. But this will surely change, with ageing plants in western Europe more at risk than newer plants in CEE.

One effect of the economic crisis is that it has eased some of the upward pressures on labour costs, making CEE's competitiveness on costs better than it has been for some years.

The rush to move production to eastern Europe that made Slovakia the continent's biggest per-capita car producer has tailed off, but capacity is still being added.

Mercedes-Benz will start producing cars in Hungary in 2012, while Ford acquired a plant in Romania and is due to begin production there from next year.

In September, General Motors said it would invest €500m in its Hungarian engine plant to expand capacity. China is also showing interest in the region, which it sees not only as a market with good growth potential, but also one that can provide it with much-needed technology.

Great Wall Motor Company will start producing cars in Bulgaria from next year, while Chery Automobile is sniffing around Poland.

It is technology that is regarded as crucial to the future of the car industry in the Czech Republic, Slovakia, Poland and Hungary.

Until now, sophisticated new engine technologies have generally been developed outside the region in the home countries of the parent groups, which have been reluctant to see it leave there, fearing valuable intellectual property would be at risk.

But this is changing. For example, smaller-engine technologies are being developed in Skoda's research centre in Mlada Boleslav in the Czech Republic, and used throughout the worldwide operations of Skoda owner Volkswagen.

"The Czech Republic is becoming more developed in terms of the car parts produced there, products that are higher added-value and more complex technically," says Milan Kocka, partner at Ernst & Young.

"The easiest part of production that was shifted [to the region] in the past 10 years has in some cases shifted further east – and this is not a trend restricted to just the car parts industry, I'd say it's an overall trend."

Logan's run: the Dacia car has sold well in Germany

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Pressure of levies puts brakes on recovery

Banking

The sector is facing political challenges, write **Jan Cienski** and **Chris Bryant**

Central European banks generally came through the global crisis in a lot better shape than pessimists had predicted, but now they face pressures that come more from politicians than business trends.

Hungarian banks in particular face a variety of severe headwinds, the biggest of which comes from a Ft200bn ($1bn, €730m) financial sector levy designed to help the government meet European Union-imposed fiscal targets in 2010 and 2011.

Several Hungarian banks are expected to report losses this year because of the tax, which is by far the highest bank levy in Europe. Analysts have warned it could discourage foreign-parent banks from investing in their subsidiaries.

The government has indicated that banks may continue to face some kind of levy from 2012-2014 – albeit at about half the current level – which has added to investor uncertainty and threatens to hamstring the economic recovery.

"In response to a lower profit outlook, banks will pursue more conservative policies and curtail lending. This, in turn, means that neither economic output nor internal consumption can grow at the expected rate," say analysts at Political Capital, a Budapest think-tank.

There are also concerns that the bank levy – which has widespread popular support – could serve as a model for other countries in the region.

Poland is considering a bank tax to take effect in January; a step that Jacek Rostowski, the finance minister, says will protect the sector from future shocks.

However, Polish banking executives fear the cash-strapped government is more interested in raising revenue than in shoring up banks, which did not need any state help during last year's crisis.

Although there had been fears in Poland and elsewhere in the region that foreign-owned banks, which play a key role in all local banking sectors, would drain liquidity from their affiliates, the reverse happened.

"The government did not need to support the banks or provide emergency liquidity," says Stephane Hild, the head of Société Générale in Poland.

In Slovakia and the Czech Republic, where the bank systems proved to be solid last year as well, the new centre-right governments have little enthusiasm for a banking tax, with parliaments in both countries rejecting the idea.

Hungary's banks were already on the back foot because of troublesome foreign-currency loan portfolios. Hungarians had feasted on forex loans before the crisis because of the low interest rates on offer. About two-thirds of household debt in Hungary is denominated in foreign currency, of which the vast majority is in Swiss francs.

As the Swiss currency appreciated against the forint this year, borrowers' repayments became more expensive, contributing to an acceleration in non-performing loans.

Poland, where such loans were also popular, had much tougher banking regulators, and foreign currency loans make up only 36 per cent of total lending.

> 'The [Polish] government did not need to support the banks or to provide emergency liquidity'

The regulator has proposed limiting foreign currency loans to 50 per cent of a bank's loan book, which has upset the sector. However, many banks are already moving in that direction on their own.

Zbigniew Jagiello, chief executive of BKO Bank Polski, the country's largest, says foreign currency lending essentially ceased in 2009. Loans now tend to be denominated in euros rather than Swiss francs and make up about 15 per cent of his bank's new loans.

"The crisis changed our approach to individual mortgage clients," he says.

Hungarian banks also face tighter regulation, including higher costs from new rules designed to help troubled borrowers. A moratorium on foreclosures and evictions, as well as an effective ban on foreign currency lending, the most lucrative part of their portfolios, is likely to put downward pressure on their earnings.

By contrast, Polish banks are doing well. Most remained profitable throughout the crisis and, in spite of non-performing loans growing from 4.5 per cent of banks' portfolios in 2008, to 7.6 per cent at the end of last year, profits are likely to be up this year.

Mr Jagiello says his bank earned 2.4bn zlotys ($836m) in the first three quarters of this year, more than it made for all of last year.

Life was more difficult in Slovakia, where the small and open economy contracted by 4.7 per cent last year. That, combined with the loss of forex revenues owing to euro adoption at the beginning of the year, cut profits by more than 50 per cent.

Slovakia's economy has rebounded strongly this year, thanks to Germany's revival, and Jozef Sikela, chief executive of Slovenska Sporitelna, the country's largest bank and a unit of Austria's Erste Bank, says his bank earned €95m in the third quarter, more than for all of 2009.

Although profits fell last year, the stability of the sector was not in doubt, in large part because of the reluctance to grant foreign currency loans.

"The plain vanilla business of collecting deposits and financing customers whom we know was the right decision, because it helped us survive the crisis," says Mr Sikela.

Forex loans were also not an issue in the Czech Republic, where interest rates have traditionally been below those of the eurozone.

Czech banks are traditionally very conservative, which meant they did not dabble in the exotic instruments that caused trouble for some of their parent banks in western Europe.

Tangled up in blue: an EU flag is coiled by wind outside the Hungarian National Bank Getty

Profile Gedeon Richter strikes out westwards

Gedeon Richter, Hungary's largest pharmaceutical producer with annual sales of €1bn, has long been one of central Europe's stock market favourites.

Based in Budapest, and with a mixture of 20 per cent proprietary, 80 per cent generic production, Richter has a "first-class" management team that is "experienced, forward-thinking" and contains "clear communicators to the investment community, albeit tending to err on the side of caution", says Luke Poloniecki, pharmaceutical analyst for Europe, Middle East and Africa at ING in London.

But as Zsuzsa Beke, Richter's public relations chief, admits, equity analysts had begun complaining in recent years that the company had been holding too much cash.

This autumn, the analysts found out why, as the company swooped twice in quick succession to acquire western operations, at an immediate cost of €350m.

First came PregLem, a privately owned Swiss biopharmaceutical company, which took a SFr100m (€114m) down payment, with a projected additional SFr295m in milestone payments to come.

Less than a month later, Richter picked up the oral contraceptive portfolio of Grunenthal, a family owned, research-based company based in Germany, for €236.5m. The deal received approval from the German antitrust authority last week.

Erik Bogsch, Richter's chief executive, says the two deals were "the biggest achievements of the year for the company", and would prove to be "important steps" in furthering its drive to boost the value of its drug portfolio while simultaneously improving its salesforce in key western European and other international markets.

The company had already sent feelers beyond eastern Europe, establishing joint-ventures in India in 2004 and in Germany, in 2007.

These, together with its latest drive westward, mark it out as something of a pioneer. "I believe that these deals make us the largest Hungarian investor in western Europe," says Ms Beke.

Not that such moves were entirely unexpected. "It's tempting to view these deals as a turn in strategy, but it's very consistent and in line with Richter's therapeutic focus; its gynaecology specialisation [the business focus of both acquisitions] has always defined the company," says Mr Poloniecki.

Mr Bogsch is quietly confident that Richter can create additional value from its newer acquisitions, citing the potential value of PregLem's development portfolio, which includes Esmya, a drug for treating uterine myoma (a fairly common female condition) and which has completed final, Phase III clinical trials.

"If the [Esmya] registration goes through, then really it fulfils an unmet clinical need, so it would really be a very important product, with potential [annual] sales of €100m–€200m in Europe," says Mr Bogsch.

Meanwhile the German acquisition adds Belara, the well-established, contraceptive brand, to Richter's product line, and enables the two companies' sales forces to combine efforts to sell the enlarged portfolio in their respective areas.

Both deals inevitably involve uncertainty, notes ING's Mr Poloniecki – particularly the PregLem purchase, as none of its products are yet licensed. However, the progress in clinical trials of its two leading products indicates these "may have a better chance of success" than most drugs under development for female ailments.

And with Richter holding some €400m in cash, the deals should not strain finances (the company has also indicated it is pulling together a loan deal to ease any potential difficulties).

Mr Poloniecki says: "Investors will be encouraged to see Richter spending from its cash pile, and purchasing assets in line with its therapeutic specialisation and its corporate strategy of expansion into western Europe."

Kester Eddy

Erik Bogsch: has high hopes from acquisitions

Plans diverge after recovery

Continued from Page 1

demands spending cuts, the government is keeping a close eye on the political calendar, mindful of parliamentary elections that take place next year.

The government is "working on the fundamental assumption that Poland does not need new shock therapy", says Jan Krzysztof Bielecki, a former prime minister who is one of premier Donald Tusk's leading economic advisers.

That assumption may be correct, but if there is another wave of investor panic, Poland's budget situation could make it vulnerable.

The new centre-right government in Hungary is also tackling its much more dire economic situation – it has a debt of 78.9 per cent of GDP, much higher than the rest of the region – by mixing a dash of populism and nationalism with its fiscal tightening to inflict as little pain as possible on voters.

The government of Viktor Orban clashed with the EU and the IMF over its reform programme, and is now relying on undoing pension reforms, and new levies such as a controversial banking tax to reduce the deficit and deliver a promised tax cuts.

While the crisis did uncover some weaknesses, there were strengths as well. Despite earlier fears, banks proved stable, in large part because they had not engaged in the risky investments that brought down their west European and US counterparts. Export industries, particularly the car sector, have quickly recovered.

Joining the EU has proved to be transformational. Although there have been stutters, such as the corruption that flourished on EU-funded projects under Slovakia's previous government, the regulatory norms and the enormous stream of cash pouring from Brussels are changing the region.

Poland, which is getting €67bn from 2007-2013, has become the EU's largest construction site, as towns and villages which used to dump waste into local rivers now have sewage plants, and large chunks of the countryside have been dug up for highways.

"It is impossible to overstate the impact of these funds. No country has ever gotten so much money in one go – not even Spain," says Elzbieta Bienkowska, the minister of regional development. "Poland had a slowdown but not a recession because of EU funds."

Similar projects mean that Slovakia will eventually have an east-west highway, allowing investment to flow to poorer regions near the border with Ukraine, while the Czech Republic will be even more tightly integrated with the German economy.

But in Romania a more pressing concern is the overall absorption of EU funding, which ranks among the weakest in Europe.

The country's infrastructure requires considerable upgrading – not least its motorway network, which remains tiny for a country of its size. But after joining the EU in 2007, Romanian applicants and the country's bureaucracy were unprepared to handle the complex process required to access EU funds.

The difference in absorption capacity shows the distance various countries still have to travel before achieving the long-term goal that does unite the region – catching up with west European living standards as soon as possible.

When that objective is reached, something that should happen over the course of the next generation, there may be no need for the term "central Europe" at all – Europe may do just fine.

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Beachhead to west is big attraction

Chinese investments

Not everyone is happy with the sight of business delegations trawling for opportunities, write **Jan Cienski** and **Chris Bryant**

During the Cold War, central European communists sometimes looked to China as a counterweight to their overbearing Russian rulers. Now, following the crisis-induced slowdown in foreign investment, the region is again seeking salvation from the east.

Countries across central Europe are hosting Chinese delegations, and eagerly anticipating Chinese factories and construction companies. For the Chinese, central Europe also carries attractions, as a region which is part of the European Union, but where wages are a fifth of those in Germany.

In fields as diverse as information technology, telecommunications, car manufacturing and infrastructure, Chinese companies are increasingly targeting the region as a beachhead for European expansion.

A Chinese delegation was recently visiting Poland, exploring the possibility of helping build a high-speed rail network. Poland, a laggard when it comes to infrastructure, could take a lesson from China, which has rapidly built up one of the world's most modern networks, now totalling about 7,000km.

Chinese infrastructure experience also paid off for the China Overseas Engineering Group (Covec), which, as part of a larger consortium, last year won two tenders to build 50km of an east-west highway in Poland. The Polish infrastructure ministry was counting on paying 2.9bn zlotys ($1bn) for the work, but Covec's winning bid came in at 1.3bn zlotys – 23 per cent lower than the next best.

Polish companies cried foul because Chinese labour will be used and the road builders' industry group wrote to the European Commission charging that the bid was unfairly low. The Commission has also raised concerns about the project, because it is partly funded by the EU and because China restricts entry to its own market, while competing in Europe.

That view finds little appeal in Warsaw, as the government is keen to build as many roads for as little as possible. "It is all decided by price," says Magdalena Jaworska, the deputy head of the government road-building agency.

Despite the high-profile examples, commercial ties with China are still comparatively modest compared with its large resource-linked investments in Africa and central Asia.

Nevertheless, the sight of Chinese business delegations trawling the region for business opportunities has sparked concern among some western competitors.

German industry's Committee on Eastern European Economic Relations warned last month that state-owned Chinese firms were securing an increasing number of contracts in the region "via price-dumping, aggressive financing and generous risk-guarantees".

Some analysts cast doubt on the notion that China has an overall strategy for eastern Europe, arguing that most investments are opportunistic.

"The Chinese go where there's a good deal, or they can acquire technology or resources, where the price is right and where the political environment is favourable," says Paola Subacchi at Chatham House, the London think-tank.

For some companies, central Europe is an attractive beachhead to penetrate the wealthier markets to the west. A good example is Huawei, the world's second-largest telecoms equipment maker, which broke into Europe by helping set up Play, Poland's fourth mobile telephone network.

In May last year, Huawei established an assembly plant and logistic centre in Hungary to serve customers in Europe, Russia and north-west Africa.

"Hungary and CEE have huge potential and are an area in which further investments from both Huawei and other leading ICT vendors are likely," says Gavin Dai, managing director of Huawei Hungary.

Hungary is making particular efforts to woo Chinese investors. In June, Wanhua Industrial Group, the chemical conglomerate, agreed to pay €140m for a 38 per cent stake in BorsodChem, the Hungarian isocyanate producer, indicating it would soon exercise a call option to buy the rest of the company from owners Permira and VCP Capital Partners.

"Once [the Chinese] have made a decision to march . . . they march. We will see a significant increase in transactions in which Chinese investors commit capital to European companies," says Heinrich Pecina, senior partner at VCP.

> 'Once [the Chinese] have decided to march . . . they march. We will see a significant increase in transactions in which they commit capital to European companies'

Chinese delegations are also touring the Czech Republic, where Chinese investments total about $40m, and Slovakia, where Guangzhou Echom Science & Technology reportedly plans to build a €29m plant to make television set cases. The car industry is also interested in Slovakia, Europe's largest car producer on a per-capita basis. Poland's government investment agency says Chinese investment so far totals $390m, and has hopes of more.

The trade relationship with China is not inconsequential. Hungary had trade worth $6.8bn last year. Poland's bilateral trade is worth about $16bn, while the Czech Republic has net trade of $11bn, but everywhere the balance is heavily skewed towards China, which exports TVs, cars, clothing and consumer goods to central Europe, while relatively little flows the other way.

Road to ruin or salvation? A consortium including Chinese interests is working on Poland's east-west highway Getty

Takeover is Hungarian rhapsody for Electrolux

Investor profile
Lehel

Kester Eddy hears how a state-owned refrigerator factory lost its wild cats but became a success story

When Electrolux, the Swedish white-goods maker, took over Hungary's state-owned Lehel refrigerator factory in 1991, the first decision for the newly appointed chief executive was to choose the name of a tiger cub, born recently in the local zoo.

"Lehel owned many assets in the area, including a hotel, sports facilities, and the zoo," says Janos Takacs, regional chief administrative officer for Electrolux Eastern Europe. "The animals had to be named and entered into the accounts. Mind you, the zoo was one of the first things the company sold, or rather, transferred, to the local [Jaszbereny] community."

Thus was the somewhat quirky beginning of arguably one of the most successful privatisation deals in central and eastern Europe.

However, downsizing the inventory of wild cats was far from the only change needed at the central Hungarian plant, which then boasted a workforce of almost 4,600.

"Of these, some 1,000 were white collar workers, and fewer than 2,000 were directly involved in production; this was a reflection of the [former communist-era] policy to maintain full employment," says Mr Takacs.

Worse still, despite the bloated office headcount, just two people spoke English, while modern marketing, logistics, accounting and financial skills were notable for their absence.

Despite this, Lehel workers produced 600,000 refrigerators annually, of which a third were exported to western markets. "We'd been around since 1952, and Lehel had a technical culture and experience," he notes.

Restructuring saw the total headcount dip below 3,000 by 1994, as the new owners initiated sweeping retraining programmes, and introduced new technology, production systems and product lines, while simultaneously undertaking a huge environmental clean–up – a requirement of the privatisation contract.

"The Lehel acquisition was the first 100 per cent takeover of a big state-owned company in Hungary. This was a show of trust and courage, because at the time [just one year into the new democracy] there were financial and political risks," says Mr Takacs.

As the company transformation progressed, Electrolux management increasingly warmed to its Hungarian subsidiary, introducing important new products, such as chest freezers in 1997 and vacuum cleaners in 1998 – despite suffering a serious fire in a refrigerator production unit that same year.

The acquisition of Lehel was a show of trust and courage because of financial and political risks at the time, says Janos Takacs

At the same time, Hungarian specialists were busy transferring their new skills and know-how to a freshly acquired cooker production facility in Satu Mare, just over the border in Romania.

More significant still, Electrolux decided in 2003 to develop a greenfield plant at Nyiregyhaza in north-eastern Hungary, to produce a new range of fridge-freezers.

Not that the expansion came easily. "We had to lobby hard for this; there was fierce competition," Mr Takacs says. The new plant, an investment of some €85m, opened in 2005.

The result today is a workforce across the two Hungarian sites of 4,000, including 3,500 blue-collar workers. The factories produce 5m units a year, ranging from vacuum cleaners to built-in refrigerators.

As for the investment environment, Electrolux, as a manufacturer, is not directly affected by government moves to impose special taxes on banks, utilities and large retailers. He is, however, sceptical of promises that the extra charges will not be passed on. "Sooner or later, these costs will reach the final customer," he says.

However, Mr Takacs remains optimistic, and proud of "the loyal workforce", a result of Electrolux's policy of "trusting Hungarians" and retraining rather than making wholesale dismissals.

Jozsef Csibra, a workshop leader in one production unit, appears to epitomise this policy. An employee of 15 year's standing, including a stint with Electrolux in China, he says: "My grandfather, father and now I work here; three generations all told."

Roma face a rough ride in jobs market

Social affairs

Viera Samkova's plight has touched a raw nerve, writes **Tom Nicholson**

Investing in a region's future is not just about building factories and updating the infrastructure – making the most of human assets is also vital, as Viera Samkova's story illustrates.

Ms Samkova is something of a rarity in Slovakia – she is a Roma with a university degree.

But in other ways, her situation is common. Since graduating from teachers' college four years ago, she has not been able to find work, and has watched as jobs she was told had been filled were later given to less qualified non-Roma applicants.

Ms Samkova's case, which prompted a parliamentary inquiry in Bratislava this autumn, suggests an intractable problem: if even the most educated Roma can be denied access to mainstream society, what hope is there for the hundreds of thousands of gypsies who live in primitive slums across central and eastern Europe?

"Roma, in particular, need examples in their community to follow, but the example I seem to have set for our people is that it doesn't pay to go to school and try to do something with your life," says Ms Samkova, 27.

"Mostly they laugh at me, saying I invested all that time and money and still no one wants me."

As a political and social challenge, the Roma are never off the agenda in Europe. This is especially the case now, following France's expulsion of thousands of Roma from illegal camps this summer, and the impending extension of the Schengen area next year to include Bulgaria and Romania, home to an estimated 2m of Europe's most impoverished Roma.

If it had not been for Schengen, there would have been no mass exodus of the Roma to France, Václav Klaus, Czech president, said at a meeting of regional leaders in Prague this month.

Mr Klaus and his counterparts urged the European Union to adopt a common policy on the Roma. "None of the countries that are dealing with this problem is capable of handling it on its own," said Ivan Gasparovic, Slovak president.

Hungary, which assumes the rotating EU presidency in January, has promised to make the Roma one of the pillars of its tenure.

There are signs that change is afoot below the rhetoric.

In Hungary and Slovakia, where summer elections produced new governments, the Roma agenda has been assigned to deputy ministers rather than to impotent cabinet appointees as in the past. The two countries are also now treating the plight of the Roma as primarily a social issue rather than an ethnic one.

Miroslav Pollak, adviser to the Slovak cabinet on Roma affairs, promises to end the practice of assigning Roma children to "special" schools for the mentally handicapped, and instead to reintegrate them into the mainstream education system. The government also plans to reform the social security system to motivate the poor to work, and to distribute welfare through electronic payment cards rather than in cash, partly to combat usury in Roma slums.

"We have 10 mayors and municipalities that are willing to take part in a pilot programme next year. By the end of our tenure, I expect it will be rolled out across the country," says Mr Pollak.

The change in course on the Roma was a matter of necessity rather than ideology, he adds. "The issue has been neglected for so long that it has become an economic and a security concern as well," he says.

"Governments only act when they are forced to, and at the back of everyone's mind was the knowledge that this country cannot afford to have a large part of the population excluded from economic activity. The same goes across the region – governments in central Europe were forced into co-operation on the Roma by these expulsions from France."

Ms Samkova, who ought to know, says reforming welfare and educating the Roma make sense only if workplace discrimination can be overcome.

"If we can't get jobs, it's all for nothing," she says.

Since taking her story to the press, Ms Samkova has been hired by Slovakia's labour ministry as a local adviser on Roma issues. But the contract is at the minimum wage, and ends in the new year.

"I'm grateful that finally someone in the government helped me out," she says, "but it looks like in January I'll be back where I started."

Out of luck: Viera Samkova Radio Expres

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