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Central and Eastern Europe in the global context

How the business potential of CEE compares with that of China or India

By Libor Safar and Arturo Quintero

Today, more than 17 years after the fall of the Berlin Wall, the region of Central and Eastern Europe (CEE) is thriving. The CEE region has become a major services and production base for Western European and US companies, and increasingly also for businesses from Japan, Korea, China and India. While the emerging markets of India and China are very visible, and are the hot topics for media and analysts alike, the CEE region as a whole enjoys somewhat less media space. This article provides some basic comparisons of the CEE region with China and India – where they differ markedly and where they share similarities, primarily from the business perspective.

Regionalization

One aspect these regions have in common is the opening up of their economies and their inclusion in international trade and globalization trends in general over the past few decades. During this period, they have attached themselves to the existing “triad” of the major regional trading blocs of Europe (the European Union), Asia (Japan, APEC and ASEAN), and the Americas (NAFTA), and have established themselves as up-and-coming economic partners.

The CEE region has benefited from the proximity to – and for many countries, membership in – the EU. The region has become a major manufacturing base for sophisticated industries such as the automotive sector, and enjoys fast-growing popularity as an outsourcing center for high-tech and R&D industries. Effectively, it has become a “near-sourcing” location for the whole of Europe, offering the advantages of a talented and educated workforce, lower costs of living and labor as well as cultural proximity.

China and India are close to the Asian trading blocs. China is a member of APEC (the Asia-Pacific



Photo: Sanja Gjenero

Economic Cooperation) forum, a loose grouping of the countries bordering the Pacific Ocean. Recently China has also started to sign bilateral free trade deals with a number of individual APEC member countries. The impact of the regional trading blocs has now also prompted the members of the 10-strong Association of Southeast Asian Nations (ASEAN) to accelerate plans to create a single economic community. Countries such as Thailand, Singapore, Vietnam and others hope that this will enable ASEAN to compete more efficiently against the fast-growing larger economies of China and India. ASEAN members now hope to establish a single trading market, similar to the European Union, as early as 2015.

To complement the triad, NAFTA (the North American Free Trade Agreement, encompassing

the USA, Canada and Mexico) countries benefit in a similar way from the proximity of the Central and South American countries such as those clustered in the Central American Free Trade Area (CAFTA) encompassing Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic, and also from the relative proximity of the Mercosur countries (Brazil, Argentina, Uruguay, Venezuela, and Paraguay). The CAFTA countries in particular are well positioned to profile themselves as the near-sourcing center for the Americas, providing offshoring operations to the US, making use of the same time zones and proximity to North American markets. While NAFTA has gained ground since its implementation in 1994, plans to create a Free Trade Area of the Americas (FTAA) that would include the rest of Latin America are currently on hold.

The effects of globalization

The globalization trend, which may have started over the last 25 years or so, and from which the CEE countries as well as India and China have largely benefited, is by no means a given. We often like to think that we live in unique times, and perhaps to some extent we do, but globalization is not a new concept.

In terms of finance for instance, according to some measures, capital flowed more freely across frontiers in the late 19th century than today. The net outflow from the then imperial powerhouse Britain rose to as high as nine percent of GNP in that period. By contrast, even at their peak in the 1980s, net capital outflows from Japan and Germany never exceeded five percent of their national outputs. The difference today is that the flow of capital is becoming increasingly bi-directional.

In the late 19th century, there were also major movements of people between countries, regions and even continents. This is not a major feature of today's globalization. Then, the momentum was lost, and it may equally be that the current trend towards globalization will cool down. If that happens, however, it is quite likely that China, India and the CEE will find themselves in a much stronger position vis-à-vis the other global economies.

Unity and diversity

When evaluating the market potential, the CEE is a region encompassing a population of some 90 million, comprised of a number of countries, which share some common cultural and historical perspectives, but are independent nationstates, each with their own language and identity. Products sold on these markets will require localization or translation into these individual languages, and today, the languages spoken in the CEE region are an established target for most companies localizing products for the European marketplace.

In contrast, China and India are single countries and by far the most populous in the world, with China's population exceeding 1.3 billion people, and India's greater than 1.1 billion. While the economies of scale when launching localized products in these countries are obvious, the countries are far from homogeneous. In the case of China, for instance, producers need to consider the differences that exist in the Chinese language,

with its seven to ten main classified dialect groups, some of which are mutually incomprehensible. These spoken dialects do not differ largely in their standard written form, which depending on the country uses the Simplified Chinese character set (PRC, Singapore) or the Traditional Chinese character set (Taiwan and the rest of the Chinese-speaking world).

Microsoft's Windows operating systems provide an example of a good support in this respect. The latest Windows Vista™ operating system is available in Simplified and Traditional Chinese, as well as a special Traditional Chinese for Hong Kong.

In contrast, India provides for a much more complex market regarding localization and translation. India has 23 official languages (including Hindi and English), and of the 1,652 (according to the 1961 census of India) mother tongues in India, 24 languages are spoken by a million or more people.

The business potential in India has been recognized by Microsoft, who has extended further the number of Indian languages in which their operating system is available with Windows Vista™. During 2007, Windows Vista™ is set to become available in some 15 Indian languages, including minority languages spoken in parts of India that were not previously supported by Windows XP, such as Pashto and Assamese. This allows many more people access to software in their own language, and also sets a precedent and encourages other software producers to bring their products to the market in these local languages.

Labor considerations

Talent has become a global resource, and attraction and retention of talent is one of the keys to success for companies. In this respect, the CEE region, China and India are places which are providing a large supply of talented and qualified resources. Certainly labor costs, which are lower in the CEE region than in the west, and lower still in India or China, have been one of the main drivers. But it is also the sheer number of graduates who become available every year, along with their qualifications and motivation to succeed, which are equally important to consider.

India produces an estimated 400,000 new graduates in engineering and science every year – more than any other country in the world. But the big three Indian software companies alone – Infosys, Wipro and TCS – are planning to hire 100,000 new

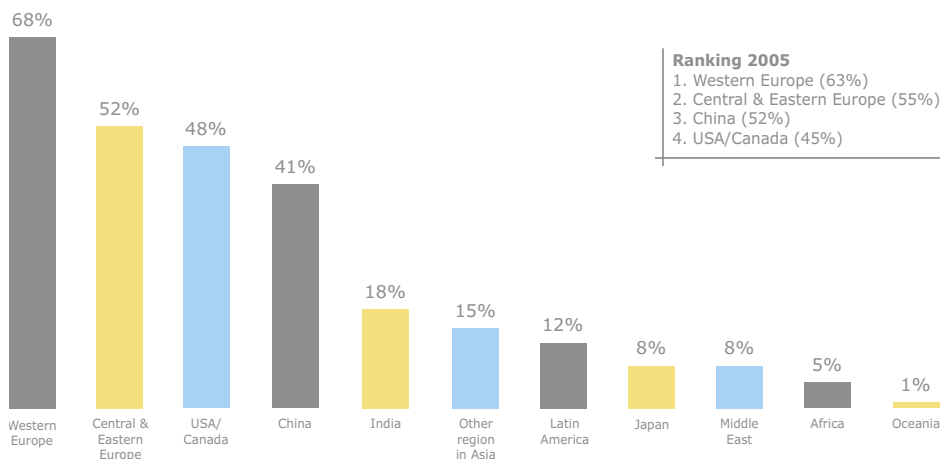
graduates in 2007. Future growth will require even higher numbers of qualified graduates, and in India, as in China, there are fears of an upcoming shortage of qualified resources. There are clear signs of the labor market becoming over-heated. This results in wage inflation, especially in local centers with a high concentration of local and foreign operations, and deteriorating staff retention. These trends exist in the CEE countries too, but are less acute, and certainly the labor costs are not set to rise as dramatically in specific industries. Also, although the CEE region produces a lower number of university graduates than India or China, they are on average found to be more suitable to work for multinational companies according to the McKinsey report *Sizing the Emerging Global Labor Market*.

Cost of doing business

While labor costs in India or China are lower than the CEE average, they are only part of the total cost of doing business. Because the business and overall technical infrastructure in China and India is still developing, other associated costs are often considerably higher than in the CEE region. This applies to support services such as accounting or legal services, where working with knowledgeable partners familiar with the international environment and well equipped with foreign language skills will necessarily bear higher costs than where these skills are not such a limited resource. Equally, the costs of IT infrastructure are not markedly lower in China and India, and some, such as fast and reliable internet connectivity, are often higher than in Europe. This is certainly one of the factors contributing to the pressing need to achieve economies of scale in China. Since non-labor costs can be high, it takes a large scale and a high degree of utilization to be successful, and this has been at the top of the agenda of many a Chinese enterprise.

The close proximity of the CEE countries to the rest of Europe as well as to North America in terms of culture, ethics and business and management practices, is a major competitive advantage of the region. In addition, the fact that – today – much of the region is already part of the European Union, and hence shares the same legislature and legal frameworks, simplifies doing business in the region dramatically, and reduces costs and risks. Ultimately risk reduction leads to the reduction of overall costs, which compensates further for the lower hourly rates for labor in China or India.

The most attractive global areas 2006 (total superior to 100% - 3 possible choices)



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Overall attractiveness

In the 2006 edition of the annual Ernst & Young European Attractiveness Survey, titled *Team Europe Defends its Goals*, one of the conclusions given is that Europe, as a region on the global scene, "reinforces its position as the location of choice, thriving on Western Europe's maturity and Central Europe's dynamism." Based on the survey, which was conducted among 1,019 international business executives from Europe, North America and Asia, Western and Eastern Europe remain the top two business locations of choice, followed by the USA and China.

Overall, the attractiveness of China (as measured by the E&Y survey) has fallen considerably compared with 2005, from 52 percent to 41 percent, while India remains the fifth most popular global region with 18 percent, unchanged from 2005. What is a remarkable change compared with 2005 is that now primarily small-to-medium enterprises (SMEs) find investing in China attractive, whereas previously this was mostly the large multinational companies.

Key factors

Companies evaluating the CEE region against China or India come from different industries and work in different environments. Nevertheless the following are some of the major universal factors that make for the attractiveness of the CEE region:

► **Same time zone** – The fact that the CEE is located in the same time zone as much of

Europe allows exploring the critical advantages of unlimited communication. Even though much of the IT-related services are today less vulnerable to the issues resulting from communicating across long distances, this continues to be an important convenience and comfort factor.

► **Geography** – All the CEE countries are easily accessible, thanks in part to the immense increase in intra-European air links between most major cities and even minor ones. For product shipment this translates into speed and low costs of transportation.

► **Legislation** – The fact that most of the CEE countries are now EU members means they share the identical or harmonized legislature covering anything from trade, labor, and regulatory affairs to consumer regulations. Among other things, this also dramatically reduces the costs and requirements for administration.

► **Cultural proximity** – The shared cultural background and heritage, and the largely shared set of assumptions and human experience, can streamline communication considerably. In terms of the business environment, this results in an overall compatibility with prevailing business culture and ethics. In addition, the CEE

region offers a wider diversity and access to knowledge of foreign languages other than English.

► **Skill pool and costs of labor** – The CEE region provides a large pool of educated, well-trained and motivated resources with up-to-date skills. The hourly costs of labor are higher than in China or India, but still lower than in Western Europe. The European countries in particular are well-positioned to make use of this advantage, before it becomes less significant as the wage levels in Western and Eastern Europe equalize.

► **Market potential** – Even though as a whole the CEE region is a smaller market in terms of population than China or India, it is still significant, has higher-than-average purchasing power, and is marked by fast growing national GDPs and an overall affluence of the population.

► **Pan-European benefit** – Given the high degree of integration between the individual EU member countries, in most cases what benefits one region has – sooner or later – a beneficial effect on the whole. The EU is becoming a larger market and the CEE region increases the overall attractiveness of Europe as a market as well as the place for foreign investment.

The individual CEE countries alone may find it hard to compete with the emerging giants of China and India. But as a region encompassing a diverse yet coherent set of countries with cultural, business and geographical proximity to Western Europe, it provides for a growing market as well as smart outsourcing location. Overall, it is well-positioned for European companies to explore this potential, as it is for those who want to make the CEE region a springboard for their expansion into the whole of Europe.

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