MultiLingual
Language | Technology | Business
MultiLingual Computing, Inc. • 319 North First Avenue, Suite 2 • Sandpoint, Idaho 83864-1495 USA • 208-263-8178 • Fax 208-263-6310

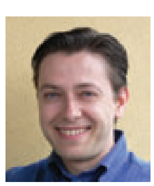
Region Focus

Globalization offshoring in Central and Eastern Europe

Libor Safar

Over the past 15 years, a number of countries and regions have emerged and profiled themselves globally as popular destinations for offshoring. Each major developed industrial region, it seems, has its offshoring production or manufacturing base located conveniently nearby. Central and South America for North America; Central and Eastern Europe (CEE) for Western Europe; and China and India not only for Asia Pacific, but — as with the rest — having a global impact, too.

Among these major outsourcing regions, differences exist in terms of their specialization, driven by the specific country conditions and development priorities. China is a major manufacturing base, and India has become synonymous with outsourcing of IT, services and back-office operations on a global scale. CEE as a whole is becoming the home of outsourcing operations for a large number of European and US companies, with increasing forays of companies from Asia.



Libor Safar is marketing manager at Moravia Worldwide, based in the Czech Republic.

What do we mean by CEE here? It would be the cluster of the new (since 2004) European Union (EU) members — the Czech Republic, Hungary, Poland, Slovakia, Slovenia, Estonia, Lithuania and Latvia. This set is complemented by the countries about to join the EU in as early as 2007 or 2008 — Bulgaria and Romania. To which we need to add Russia and also Ukraine. Russia also forms part of what is known as the BRIC economies — the outsourcing economies encompassing Brazil, Russia, India and China. The remaining countries in the region, those in the Balkans and Belarus, have been on the sidelines of this trend so far, but the likely entrance of Croatia to the EU within the next few years may well bring fresh wind here as well.

The Carpathian Tigers

In CEE, it all started with manufacturing — automotive, electronics and high-tech engineering — in the mid-1990s. As a result, the Czech Republic, Hungary, Poland and Slovakia will soon reach some of the highest positions in terms of car production per capita in Europe, all because of the investment from companies such as Volkswagen, Toyota-Peugeot-Citroen, Hyundai, Kia, Audi, Renault, Suzuki, Fiat and others. After manufacturing, higher-value added areas such as R&D and design, business support services including IT, and technology centers followed, and all these are on the increase. It is almost with the same regularity as in China or India that one can hear of yet another multinational company opening a new center in the region.

Overall, the economies of the new EU countries have been experiencing strong growth since their 2004 entry to the EU, even stronger than before their accession, in part thanks to high levels of foreign direct investment (FDI). In 2005, for example, they have grown their gross domestic product (GDP) by between 3.9% and 10.2%, compared with the "old-EU" average of 1.5% or the EU-zone average of 1.3%.

Although receiving less publicity than, for instance, China or India, the scale and dynamics of the development of this region have not gone unnoticed. In its December 2005 International Cover Story, *BusinessWeek* magazine (www.businessweek.com) hailed the CEE as the next outsourcing haven for engineering and software development and talked about the "Rise of a Powerhouse." Don DePalma, from the research and consulting firm Common Sense Advisory (www.commonsenseadvisory.com), recently coined the term "Carpathian Tigers" to describe the combined growth potential of the region, as a parallel to the famous Asian or Celtic Tigers. (Note: This name stems from the Carpathian Mountains, a mountain chain which is spread across much of CEE including Austria, the Czech Republic, Slovakia, Poland, Ukraine, Romania, Serbia and northern Hungary.) Ernst & Young (www.ey.com), in its 2005 European Attractiveness Survey "Emerging Economies Stake Their Claim," concludes that the rise of CEE confirms these countries' position as China's "low-cost" competitors. Based on research among international business executives in Europe, the company found that the CEE countries seem to be the top destinations for offshoring plans among the companies surveyed that have relocation projects. The region was considered as a relocation site by 40% of these companies in 2005 (versus 29% in 2004) ahead of China, which remains stable at 22%. India is beginning to emerge (7% of plans for offshoring), mainly for US companies.

Direct investment flows to and from the countries of the Organisation for Economic Co-operation and Development

	FDI outflows in 2005	FDI inflows in 2005	Net cumulative FDI flows 1996-2005
Czech Republic	0.9	11.0	47.1
France	115.6	63.5	-379.1
Germany	45.6	32.6	-34.5
Hungary	1.3	6.7	30.9
Ireland	12.9	22.8	42.6
Italy	41.5	19.5	-47.1
Japan	45.8	2.8	-244.0
Korea	4.3	4.3	11.7
Poland	1.5	7.7	64.0
Slovakia	0.1	1.9	13.1
Spain	38.7	23.0	-107.8
Switzerland	42.8	5.8	-154.4
United Kingdom	101.1	164.5	-368.0
United States	9.1	109.8	125.7

USD billion

Source: OECD, "Trends and Recent Developments in Foreign Direct Investment," June 2006, www.oecd.org

A brief history

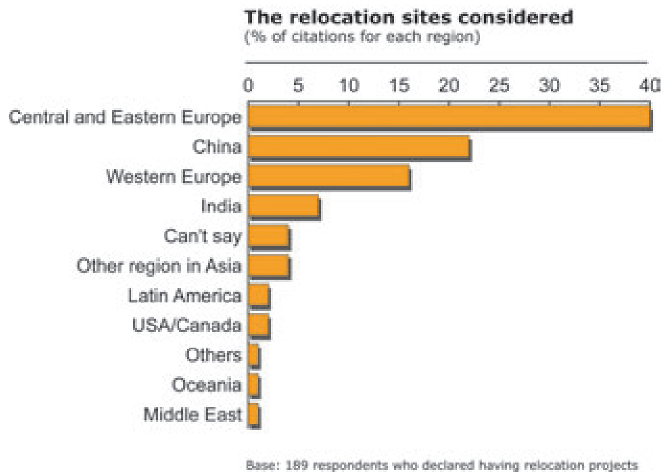
It is against this general background that the language industry has used the potential of the region for outsourcing globalization services. The language services industry has had a long and solid experience with outsourcing in general. The right balance between in-house localization teams and outsourcing to external partners has been a consideration since the early 1990s. A contributing factor has been the relatively strong resource-demanding nature of both translation/localization as well as testing/engineering activities. Another factor has been the fluctuating nature of business in the sector with frequent peaks and valleys in production, not only over longer periods of time, but also during actual projects.

For the purposes of this article, let us focus primarily on the offshoring of non-linguistic activities, the assumption being that as a rule, all translation activities should always be conducted in-country, leaving us effectively with no choice but to outsource.

Over the past 14 years that I have been with Moravia Worldwide — primarily in its global headquarters in the Czech Republic — I have seen globalization outsourcing evolve enormously in the region. Using the company as a case study to illustrate the developments, here are some of the main phases of development of globalization outsourcing in the CEE region.

1990–1994: the early years. The foundations of the future globalization industry in the region are being laid. After political changes that allowed private businesses (the fall of the Berlin Wall and the Velvet Revolution in what was then Czechoslovakia in 1989), many language services companies are founded, including Moravia in 1990, Lomac (Poland) in 1992, Logrus (Russia) in 1993, and Skrivanek (Czech Republic) in 1994. This is in response to the high increase in international business within the region as multinational companies enter the market and need translations of manuals for their products. Another driver is the still relatively low levels of knowledge of English and other foreign languages in the population. With only a small "delta" after the Western European languages, the first — though sometimes only partial — software localizations are being done in the languages which represent the larger markets in the region: the Czech Republic, Hungary, Poland and Russia. For instance, it is into this language set (Czech, Hungarian, Polish and Russian) that Microsoft released its first CEE localizations of the Windows operating system (Windows 3.1). At this stage, localizations are carried out mostly by small *ad-hoc* in-house teams at clients, resellers/distributors or enthusiasts. Later, they will be done by translation companies that start to be dedicated to software localization, primarily as single-language providers.

1995–1997: the adolescent years. Major software producers come to realize the growing potential of the markets in the region and look for more frequent, more extensive and more professionally organized localizations. Many languages (Bulgarian, Croatian, Romanian and Slovak, for example) and products see their first-ever major localization projects. The increased globalization work in the region spurs the emergence of a number of new language services providers such as Argos Translations in Poland (1996). More technical work gets outsourced to the region, which would previously have been done in-house at client locations or in some of the then-traditional localization centers such as Dublin.



©2005 Ernst & Young, "Emerging Economies Stake Their Claim," www.ey.com

These developments lead Moravia to undergo its first transformation — from a primarily Czech-language provider to a multilingual CEE regional provider. Subsidiaries are opened in Poland, Hungary and later Slovakia, and partnerships are established with other countries in the region, frequently helping to build or develop the localization industry and localization professionals in these emerging markets and leading to a "first-ever" localization project. The outsourcing trend also leads the company to adopt a centralized approach, with a separation of linguistic activities from technical, engineering or management tasks, and to centralize non-linguistic functions in the company's production center in Brno, Czech Republic.

1998–2000: the life-is-beautiful years. The developments that marked the previous phase continue to be at work, only their effect is even stronger and more prolonged. Global IT and economic growth bring more localization projects, more languages and more opportunities. Other local single-language vendors begin to open offices in other countries in the region, first focused primarily on translation services. Poland-based Lomac, for instance, opens its first office outside Poland, in the Czech Republic, in 1999. Logrus in Russia decides to expand into testing and engineering services. Some of the US and Western European vendors start to eye the CEE market and open small offices there or acquire local companies. ITP (in 2000 acquired by SDL) opens offices in Hungary and Romania in 1998. A few months later, Berlitz International, Inc. (its Berlitz GlobalNET unit later acquired by Bowne Global Solutions, which still later on gets acquired by Lionbridge) acquires Poland-based Delta Software.

2001–2002: the difficult years. The major global IT downturn, caused by the burst of the high-tech bubble, impacts heavily on the localization industry. It has a double effect on the region. On the negative side, localization into CEE languages, which are typically included as third-tier or fourth-tier languages, is reduced in scope more than others, such as German, French or Japanese. On the positive side, smaller budgets force clients to focus more on overall cost efficiencies, and the CEE region gains in significance as an offshoring alternative. This is especially the case in the areas of functional or localization testing or DTP, where clients look to outsource more of the Western European or Asian languages to the region.

At the same time, this period also exposes the inherent weakness for companies relying solely on the CEE region. Moravia's approach is to rapidly increase language coverage outside the traditional CEE languages to include the full Western European and Asian set and to open sales and account management offices in the United States and in Dublin, Ireland, the major localization hub in Europe. This gives the company a better understanding of the markets and provides for local management and same-time-zone presence — something that has been done by other companies since then. Such decisions are not easy, since expanding to regions such as the United States or Ireland is a major investment for companies originating in CEE, considering the lower cost base back home.

2003–2004: the world-of-opportunities years. The IT industry upsurge in the period leads to more globalization outsourcing to the region, as companies feel more comfortable outsourcing critical activities to eliminate fixed internal costs, but also sees the globalization industry restructure. The EU enlargement in 2004 — in which ten new countries join the EU, eight from the CEE region — brings a new and now-continuous stream of new content to translate/localize, and many regional language services providers become approved EU translation vendors.

Conversely, this increased demand leads also to a certain shortage of available professional translators and interpreters in the EU accession countries, especially in the smaller economies.

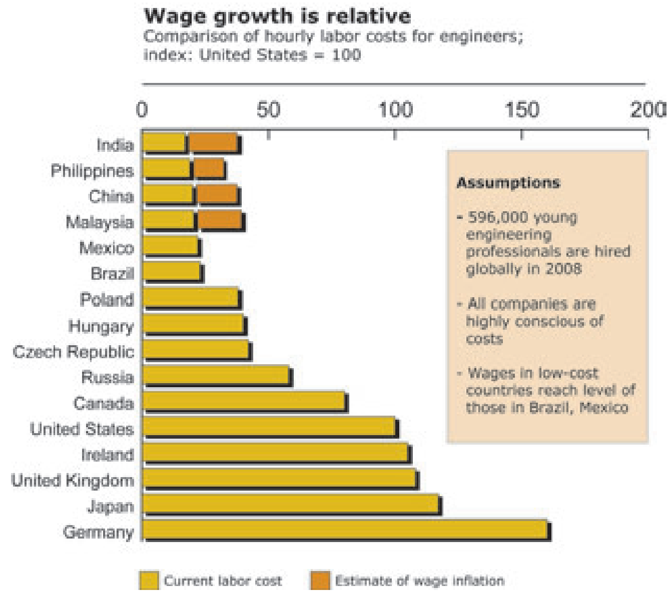
The CEE languages gain in prominence as they are backed by larger and fast-growing markets. Polish, for instance, often moves to become a second-tier language, on the same level as Dutch or Portuguese. The wave of consolidation in the industry affects the region. In 2003, SDL acquires Poland-based Lomac along with its six regional offices. Niche providers of globalization testing and engineering services grow in the region in countries such as Estonia or Bulgaria. Several companies in CEE emerge to profile themselves as regional language vendors (RLV), specializing in translating into CEE languages.

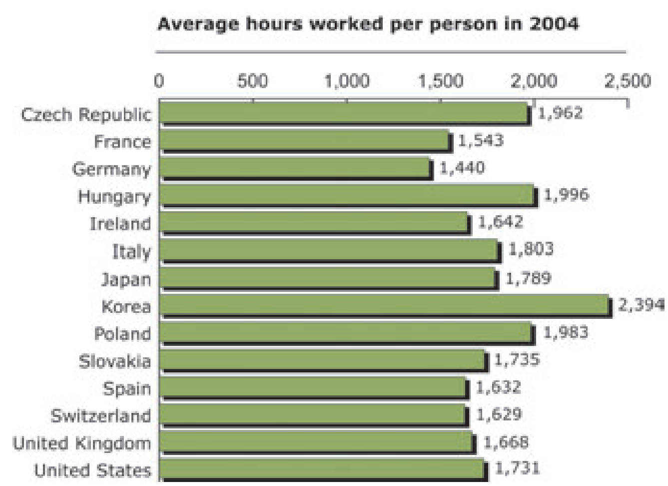
At Moravia, this global outsourcing trend leads to substantial growth of the company's separate QASight testing and engineering unit. At the same time, the company establishes a second offshoring hub in Nanjing, China. While the CEE region has a major labor quality and cost advantage, outsourcing part of the company's services to China adds new far-offshoring options.

Some clients require full outsourcing to China; some find increased security and efficiency in splitting testing and engineering services between CEE and China. This also enables the company to compete more efficiently with the growing array of native China-based testing services providers. A number of large and mature clients identify that they outsource too much into one region, specifically Asia (often more than 75% in China/India/Singapore), and want to reduce risks by working with other outsourcing regions, particularly CEE.

2005–2006+: the maturity years. By this time, CEE is firmly established as a major offshoring center, including for globalization services, where it has taken much of the leading role previously held by other localization and testing centers in Europe, such as Ireland. The overall market has achieved a higher degree of maturity. There is a well-established array of outsourced globalization services providers in the region, located in the new EU countries (the Czech Republic and Poland), in the prospective EU members (Bulgaria), and in Russia. Some of the smaller-size localization providers from Western Europe venture into CEE and open a presence there. For instance, after Belgium-based Jonckers opens in the Czech Republic, France-based WHP opens in Slovakia in 2005. Two of the companies from the region are included in Common Sense Advisory's ranking of the top 20 translation companies in 2005.

At Moravia, this phase of the market development prompts the company to expand further its worldwide presence in Japan and in other locations in the United States, which not only means the establishment of local production centers but, importantly, serves to market and sell the multilingual services that are centralized in operations hubs in CEE and China.





Source: OECD, "Labor Productivity Growth," April 2006, www.oecd.org

What is the appeal of offshoring to CEE today?

A number of factors contribute to the growing attractiveness of the region for outsourcing, and most of them apply to the globalization industry as well. What are some of these?

Labor force. Much has been written and said about the quality of the labor in the region — highly educated, well trained, motivated, achieving high degrees of productivity and flexibility. And this is all true. The technical universities in the region have maintained their quality, and they keep abreast of global technological developments. In total, CEE produces a lower number of university graduates than, say, China. But the CEE graduates turn out to be, by and large, more suitable to work for a multinational company, especially in the services sector. In globalization, compared with other service industries, we can achieve a good degree of separation of back-end from front-end or customer-facing activities. However, a large proportion of globalization staff is in direct contact with customers, even if through means such as entering data into bug databases when testing or engineering/bug-fixing.

This trend was recently confirmed by the McKinsey Global Institute, the independent think tank within McKinsey & Company (www.mckinsey.com/mgi). In their report titled "Sizing the Emerging Global Labor Market," which analyzes the potential availability of offshore talent in 28 low-wage nations, they find that candidates from Eastern Europe had the highest suitability rates across all occupations.

McKinsey defines suitability as encompassing factors such as language skills, education and its applicability in practice, and cultural fit including a number of other soft skills. For instance, they conclude that companies interviewed would consider employing 50% of engineering graduates from Czech, Polish or Hungarian universities, as compared to only 25% from India or 13% from Brazil. Russia and China ranked even lower on suitability, and only 10% of Russian and Chinese engineering candidates were found suitable to work for multinationals. This shows that the quality of available labor is as much important as the quantity. The pool of available resources for globalization offshoring is not limitless. In fact, there are fears of the upcoming shortage of qualified suitable labor in China in the near future.

While the CEE labor market benefits from its young and enthusiastic people, one of the challenges continues to be the relatively lower level of management skills available. But here, too, things are progressing, thanks to the increasing numbers of management schools and programs in the region.

Cost. The economic benefits of locating operations in CEE are quickly and readily understood, and in general rising cost pressures are one of the major reasons behind offshoring. While the hourly costs for an engineer in CEE can vary between individual countries, they are invariably lower than in Western Europe or the United States. But comparative advantages between countries and regions can change relatively fast, and they do. Ireland is a case in point. It was effectively one of the first offshoring centers, and it had one of the lowest labor costs in Europe just 10 to 15 years ago. Now the costs are the same as in the United Kingdom, or higher, and Ireland is now attracting investment through higher added-value activities rather than through production costs. In some 15 to 20 years, a similar trend will happen in CEE, too. Ultimately, no lower-cost country can remain low-cost indefinitely.

An important trend over the last few years has been the sometimes gradual, sometimes sharp increase in wages in the offshoring countries. For instance, countries such as Lithuania, Latvia and Bulgaria are expected to experience a wage inflation of more than 9%, according to *BusinessWeek*. Similarly, in Moscow and St. Petersburg, wages for software engineers are said to have risen by 50% in the past two to three years. In other countries in the region the increases are smaller, but still palpable.

This problem is not unique for CEE, however. At the time of this article going to press, Wipro, one of the three largest outsourcing and software firms in India, has experienced a share price fall of 5.6% despite reporting a rise in revenues and profits, simply on the strength of rising wages, as salaries in India are climbing 15% a year in some cities. And the story is not dissimilar in China.

One contributing factor in wage increases, according to the June 2006 *Harvard Business Review* feature "Smarter Offshoring" (www.hbsp.org), has been the concentration of offshoring operations in centers such as Prague, Budapest or Moscow in CEE or Bangalore, Delhi or Mumbai in India. As a result, these centers experience a local wage inflation, as well as a relatively high attrition rate among workers. This has been one of the reasons behind Moravia's strategy to build production centers in cities other than capitals — such as Brno in the Czech Republic and Nanjing in China. But in general, although the wages in all these countries will rise, they will not reach the levels in the developed world anytime soon.

Culture. Cultural proximity to multinational clients as well as to the target markets is an important consideration — even more so because some of the providers located in the region generate more than 90% of their revenues from international clients, due to the lower local demand.

This cultural proximity is a critical element in the total costs of outsourcing. While hourly labor costs may differ among locations and may still be somewhat lower in China or India compared with much of CEE, they are inevitably only part of the total costs.

This is where the theory of transaction cost analysis, developed further by Oliver Williamson in the 1980s, has helped since to create a much broader understanding of the concept of costs within organizations. This theory examined the costs of managing and controlling individual transactions, rather than the factor costs (such as labor), and how firms are structured and how they set their boundaries in order to minimize transaction costs. In some ways, Williamson's theory has also been often used as a rationale for many decisions behind outsourcing — effectively transferring transactions from hierarchical to market governance. The cultural proximity, language knowledge, "can-do" attitude and other soft skills of the labor force in CEE all help to reduce the overall costs of conducting transactions between clients and service providers located in the region.

The work ethic that exists in much of CEE has been frequently observed and cited as a differentiating factor. The average number of hours worked by employees in CEE is normally higher than those in other regions. For instance, according to the 2004 statistical data from the Organisation for Economic Co-operation and Development (OECD), a Czech employee worked on average 1,962 hours a year and a Polish worker 1,983 hours. This compares with 1,440 hours for a German employee, 1,731 hours for a US employee or 1,789 hours for a Japanese employee. Many factors influence these numbers, but certainly the ambition of the CEE population to succeed, comparable with the ambitions of China or India, is a major factor.

Location. The advantages of the CEE region's position close to the large economies in Europe, as well as the benefits of membership in the EU with the same political and economical entity, should not be underestimated. These advantages allow companies in the region to benefit from the possibilities of same-time-zone communication and easy and fast travel between cities, now further enhanced by the abundance of low-cost airlines linking an increasing number of cities across Europe.

EU membership dramatically simplifies administration procedures and reduces costs. In the case of hardware testing, for instance, the logistics of shipping test equipment between a client in Western Europe and a test center located in CEE are basically the same as if shipped within the same country.

Conclusion

To paraphrase the famous slogan developed by the telecommunications company Orange, the future is bright, the future is CEE. In his article "How Eastern Europe Fits into the European Translation Market" (in *MultiLingual* January/February 2006 "Getting Started Guide: Europe"), Kevin Fountoukidis, CEO of Polish-based Argos Translations, predicts that a much larger share of the whole translation industry will be located in Eastern Europe five years from now. And I would agree. The CEE region seems to have the right ingredients, at the right time, to make for a compelling proposition. It is set to continue being a major and growing outsourcing destination, and this applies to the whole globalization industry as well. Global thinking and perspective are needed at any organization today, and the globalization industry is well positioned to reap the benefits of the CEE region. M