

## The Central European Scissor squeeze

**Central European countries, without exception, are optimistic about their prospects of growth and sustaining influx of direct foreign investment. But sentiments are turning sour, because of a steady wage inflation, combined with profitability still falling in a majority of industries, forcing companies to reconsider their investments. The over-excitement about emerging markets, when faced with reality, could easily turn investment trends towards other opportunities in Asia or elsewhere.**

Investment decisions are rarely taken only on the basis of rational data. The fact, that Czech Republic in the early nineties was such a popular place to open up, was obviously influenced by many subjective factors. Prague is beautiful and a lot easier to move your ex-patriates to, for instance, Warsaw. But however positive underlying assumptions are, they should also result in a profitable outcome. Growth and acquisitions are blurring factors in straightforward reporting. Growth can of course be a goal on its own. But when some cost factors rise disproportionately, like salaries, it seems consistently in the end, that plain profitability seems to become unachievable. Salaries are not the only factor that is of influence. In retail and fast moving consumer goods manufacturing it seems that some, more than others, have had different assumptions in consumer spending behavior. There are of course very profitable industries in this region; insurances, telecom and energy seem to be healthy industries. But we can't ignore the simple fact that mainly in expert and management positions salary levels seem to move in a much higher pace than growth and profitability would allow them. Is that in principle an issue? Don't we experience the same in the Western economies? Even between Western Europe and the US we see a structural difference in income levels of management and key staff. But these differences are often backed by different output, where European companies generally fall behind in productivity per

employee. The trend in Central and Eastern Europe, mainly in the Eastern part of the region, fed by extremes in Russia, is undoubtedly disproportional with year on year inflation of sometimes 20-30 percent often accompanied by the same rates in real estate prices. In Slovakia, as a part of the Detroit triangle of Central Europe, real estate price inflation will reach peaks of 25% this year, according to the Economist. If companies are at all profitable, they show sliding year on year leverages instead of growing ones, normally to be expected in a more maturing economy.

So what is the consequence of this? First of all, we will definitely experience a downward trend in foreign direct investments mainly for these countries where growth or size of population are not the most obvious investment impulses. Economies further East, like Romania and Ukraine, are still in such a growth phase that combined with its sizes of respectively 23 and 48 million inhabitants they seem to be fairly untouchable in terms of negative investment sentiments, but it is there where the highest inflation is to be seen, with Romania also showing high prices inflation as well. If all the initial positivism of emerging market economy status has worn off, the impact of narrowing margins will be felt here the most. But for all other countries in the region it cannot be that investors are cueing unrelenting like before. Our Clients are already complaining consistently for it not having an impact on decisions either to enter, invest further or simply stay out or move to other continents. Membership of the European Union will have a tempering influence on the latter. As the majority of current investors are mid-sized industries, the economical and political stability is a strong impulse to move into these markets, but also because simply they are geographically near, enabling to tap into already well developed logistic networks.

Will it have an impact on salaries when investors are not flooding in anymore? My own feeling says it won't, however economically none logic may seem that. As Talent is short across the whole of Europe and demand is high

throughout the continent, we can expect higher salaries most likely above levels in Western Europe. This is already obvious in Russia but also in Poland and the Czech Republic in certain sectors. Local Board-level candidates are paid very often more than their expatriate colleagues if you would not include housing and schooling tabs often picked up by companies for their foreign management. There are though three factors that will cause higher level management fees altogether. As said, the overall shortage of talent in Europe. Secondly, the ongoing replacement of expatriate management and thirdly, a higher demand for management of Central European origin to run businesses in the Eastern part of Europe. Doubtful though is, if this shift in demand and supply is the main driver of an ongoing upward trend. In Holland in the 18th century there was a curious phenomenon called the "mad tulip trade". Super

speculation on the market for flower bulbs reached in the 18th century caused some bulbs to reach the same prices as whole houses, just for one bulb. Simply put, this was caused by the psychological effect that there seemed to be always a buyer who wanted to pay more. Likewise there seems always be a party that is willing to pay more in salaries. But this is, like what happened to the flower bulb speculation, not something that is sustainable on the long run. Somewhere along the line companies will start to compare their margins against real costs, not against growing market promises or speculations. This of course would be a healthy, although it might have some devastating local effects. But also after a minor earth shock, where buildings have collapsed and roads have been damaged, life turns quickly normal and new structures are build to replace the old ones.

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