"Old" Europe, i.e. Western Europe, is producing fewer goods and more ideas and soft goods (design, research etc), with the "new" Europe, Eastern Europe, becoming the continent's manufacturing hub. So the manufacturing sector in the Central and East European countries continues to enjoy extremely favourable prospects, albeit with some unexpected changes: textiles, which Italian companies have traditionally offshored, are less and less competitive, and the region is producing an increasing number of investment goods

Europe's new factory comes up in the East

INDUSTRY

by Matteo Ferrazzi and Alessia Muzio

An offshore location for the textiles and clo thing sector, notable advantages, primarily because of low wages, and virgin markets to conquer: while these are the ideas commonly associated with the Central and Eastern European economies, it should be noted that these increasingly clichéd concepts are gradually becoming outdated.
Wages are rising at a sustained pace. Asian competition is putting the textile sector against the ropes. Local demand is becoming increasingly sophisticated and there is already stiff competition from local and foreign investors.
Not all these elements are damaging ones, however: quite the opposite. The Central and Eastern European economies are progressively specialising towards products with higher added value, particularly investment goods. Three manufacturing sectors have dominated in recent years: mechanical engineering (sundry products and instrumentation), automotive and electrical machinery (televisions, computers, office equipment and optical and medical equipment).
Manufacturing is now one of the main drivers of economic growth in Central and East European countries, which are increasingly turning into the manufacturing hub for the "old" Europe, i.e. the original EU member States. The offshoring of manufacturing from West to East, in particular, has played a significant role as part of a more general "integration

of trade and disintegration of production processes" at the international level (trade levels keep rising and the production process is distributed among various countries, beyond traditional borders).
As a result, the manufacturing sector's weight and importance in Eastern European economies have increased significantly in recent years, with the opposite trend emerging within the borders of the "old" Europe, where the importance of the manufacturing sector is declining rapidly, with growth mainly led by the services sector (which already makes up 65% of the economy). In other words, the "old" Europe will increasingly produce fewer "material" goods and more soft goods and ideas: research, patents and design (specialising in upstream production processes), marketing and retailing (specialising in downstream production processes).
Coming back to the East European countries and their main sub-sections of the manufacturing sector, mechanical engineering (sundry products and instrumentation), automotive and electrical machinery have the following features in common: they offer higher productivity, are markedly export-oriented and receive higher levels of foreign direct investment. FDI in particular is increasingly key to understanding all the Eastern European economies, not just the small countries that have traditionally welcomed foreign trade. To cite just one example, foreign companies already account for 43% of Romania's overall turnover, 58% of its imports and 72% of its exports. The trend is even more obvious in some service segments: for example, in most Central and Eastern European countries, foreign banks are in the majority in the banking sector. In the Czech Republic, Slovakia, Hungary and Croatia, foreign banks control over 90% of all banking activity. Favourable tax regimes also encourage the inflow of foreign investment in the services and the manufacturing sectors: the various countries appear to have decided to compete to cut corporate tax rates to the largest possible extent. This has resulted in the tax on profits dropping under the 20% mark practically all over the region, with some countries such as Bulgaria and Serbia applying a tax of merely 10 percent.
But it is in the automotive sector, where the CEE countries play a key role in the global strategies of the major international manufacturers, that the importance of foreign operators is most clearly evident. Strong international competition has made production offshoring an inevitable strategy for most of the key international players. The CEE countries are among the biggest beneficiaries of this process: the world's top 10 automotive companies, American, European and Asian, all manufacture their products for the entire European market in factories relocated to Eastern Europe. If Russia is also taken into account, the CEE countries produce close to a fifth of all cars manufactured in Europe, abut double the 2002 figure. The Central European hub is a particularly strong one as a result of new factories being set up there and the start of production of new car models in many countries including Slovakia and the Czech Republic.
Electrical machinery is another of the region's booming sectors. Offshored production has already led to the creation of proper production districts in recent years, particularly in Central European countries such as Poland, Hungary, Slovakia and the Czech Republic. The process has been accompanied by the arrival of a continuous flow of foreign investors, a clear indication of the sector's good health. In Poland, for example, Toshiba (LCD televisions), Sharp and Funai have all made new investments. The country will become the European leader in the production of televisions in the next three years, producing about 80% of the new-generation televisions on the European market.
The rapid growth of manufacturing activity in the region has also been shored up by mechanical engineering, an intermediary phase of many production chains. Demand from other manufacturing industries has given mechanical instrumentation (i.e. machines made to in turn produce other goods) a boost and household appliances also have excellent prospects: Poland in particular plays a key role in this sector, accounting for about 15% of total European production of air-conditioners, washing machines and kitchen ovens.
On the one hand the CEE countries are

increasingly specialising in medium-high technology sectors; on the other, more traditional activities are experiencing the opposite process. Despite substantial foreign investment in the past decade, cost pressures and increasing competition from the emerging Asian markets are hitting labour-intensive sectors such as textiles and clothing and leather goods, and the decline will continue. Things are changing rapidly on the cost front: in general, wages have more than doubled compared to 2000 levels

_Mikio Katayama, the chairman of the Sharp Corporation, with former Polish prime minister Jaroslaw Kaczynski at the inauguration of Sharp LCD TV in Lysomice, 200 km from Warsaw

in Central and Eastern Europe. In some countries such as Romania, Serbia, Ukraine and Russia, wages in euro have tripled or quadrupled in the same period. As a result, textile and clothing production in the area, a prime Italian offshoring destination for the past several years, is no longer competitive, barring a few exceptions related to specific technical demands (such as materials for the automotive sector and medical use) and the sector's importance will inevitably gradually decline.
Strong growth is not a preserve of the manufacturing sector: in the building sector, investments in infrastructure projects, the building of new factories and a dynamic residential and commercial property market, together with EU structural funds, have fed rapid growth. Despite a slight slowdown in 2007, there is still a large gap between demand, which remains high, and supply, which remains insufficient. The services sector will also continue to be a significant component in the growth of the CEE economies and will be increasingly marked by the demand for high standards. Many international companies are already focusing on satisfying local demand in this sector. A rapid increase in disposable household income is the key driver of the growth of sectors oriented to the retail clientele, such as retail trade and the banking sector.
As regards sector-wise evolution, the overall scenario for the CEE countries is therefore moderately positive. The consequences of a possible worsening of the American crisis remain to be seen. The Central and Eastern European countries are not directly involved, as they do not have significant trade relations with the United States. However, they could be indirectly affected by the crisis through the financial channel. In this event, three sectors would be most at risk: property, durable goods production and heavily indebted sectors. Building and property companies could become less inclined to start wide-ranging building projects until such time as the crisis winds to an end, and businesses and households could find it harder to obtain loans to finance homes and buildings. However, the demand for higher quality infrastructure and housing will play a key role, reducing potential risks and keeping the building sector one of the healthiest in many countries. Through the credit channel, there could also be an impact on sales of some durable goods, such as household appliances. Things are different as regards the automotive sector: increasing international competitive pressure could actually speed up the key industries' decision to offshore production, a choice that would benefit the CEE countries. Finally, the credit crunch could make itself felt in the more indebted sectors. In Central and Eastern Europe, this would affect sectors such as textiles and leather goods; their already weak position could worsen further in the case of a collapse in demand or financing conditions.