Changing business challenges for Western multinational firms in Central & Eastern Europe in times of the Covid-19 pandemic

Research Report
Master Class CEE 2019/20
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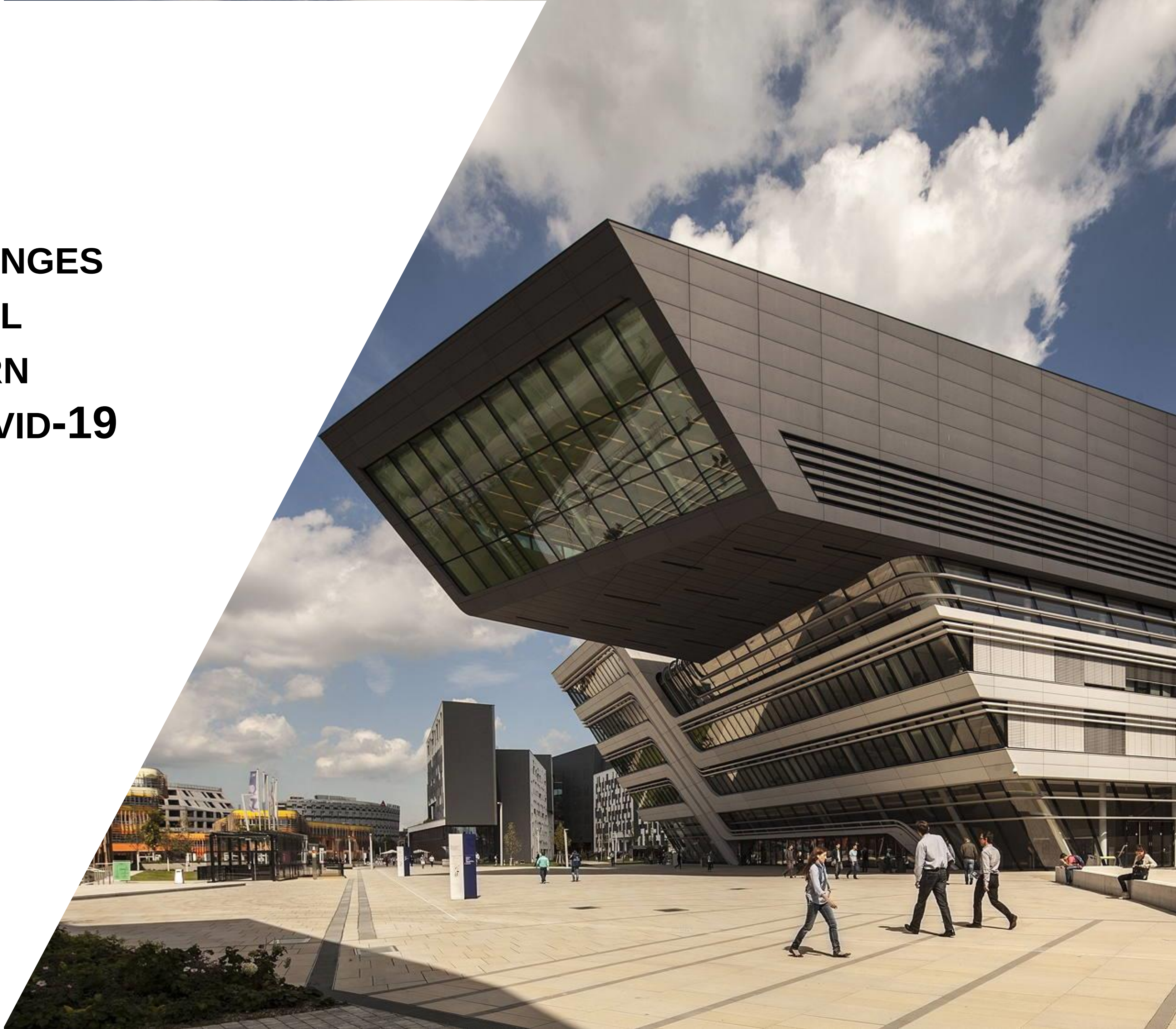


Authors and Corporate Partners of the Master Class CEE 2019/20

Students:

- Bukva Melika
- Divak Vladislav
- Grigoriță Mugur
- Huber Daniela
- Imeri Adhurim
- Kazimirovic Ivana
- Kellner David
- Mayrhofer Ferdinand
- Milanovic Sonja
- Mossgöller Jakob
- Mujanović Mirza
- Olomani Fatbardha
- Pavlovic Sara
- Pichler Lukas
- Protopopova Alena
- Sava Elena
- Szymanska Isabell
- Szymanska Katherine
- Vidović Boris
- Vikarchuk Viktoriia
- Visneider Thomas
- Voineag Maria
- Vouk Nikola Maria

Program Director & Project Leader: Ass.Prof. Dr. Arnold Schuh

Corporate Partners:

ERSTE Group

Henkel

mondi

VIG VIENNA INSURANCE GROUP

Western multinationals have to prepare for region-specific changes in the business environment

Changing business challenges for Western multinational firms in Central & Eastern Europe in times of the Covid-19 pandemic was the topic of the project seminar of the Master Class 2019/20 at the Competence Center for Emerging Markets & CEE at WU Vienna. 23 students from 10 countries and 10 master programs worked under the guidance of program director Arnold Schuh from November 2019 to June 2020 on this project.

The aim of this study was to shed light on issues Western firms have been confronted with in their operations in CEE. The following **research questions** guided our research:

- What are the predominant business challenges for Western multinational firms in EU-CEE11 countries and how are incumbent multinationals affected by these challenges?
- How does the Covid-19 pandemic influence the identified structural challenges and the future attractiveness of EU-CE11 for incumbent Western multinationals?

From a methodological perspective secondary and primary research were used. Statistics and analyses from international organizations, business consultancies and think-tanks as well as media reports were the main data sources. In addition to desk research, we talked to company representatives and experts during our field trip to Budapest and our sessions at WU.

Based on our secondary research we identified **six challenges** for the management of foreign firm in CEE. They result from distinctive developments in the local business environments, the stage in economic development and the country's position in global supply chains. These developments affect the running of local operations, potential business expansion and performance:

- **Labor shortage** and demographic decline
- New **competitive landscape**
- Tendencies towards **nationalist-populist politics**
- Decline in **institutional quality**
- Transition towards a **knowledge economy**
- Exposure to **European/global politics**

A more demanding state, new competition and faster digitalization are in the offing

Due to the Covid-19 outbreak in March 2020 we changed the course of our project and looked at the identified business challenges through the lens of the pandemic. What will happen to those **structural developments** in the EU-CEE11 business environment? Will they be accelerated or even reversed by the pandemic? And how will they affect **incumbent Western multinationals** present in CEE?

Unfortunately, the pandemic is not changing the directions of most of these trends, it is rather reinforcing them. Five out of the six business challenges paint a rather negative scenario for the operations of Western incumbents (but not necessarily for the CEE economies). While the **labor shortage** is postponed for a while, the **digitalization of** CEE economies will occur faster and push their transition to innovation-driven and knowledge economies.

Labor shortage: The shortage is now stopped by the lockdown and the sudden rise in unemployment. However, with the economic recovery the demand for labor will come back. The lack of skilled employees could hinder the expansion of existing operations. The dramatic demographic decline pose a major threat in the mid- to long-term.

New competitive landscape: While Western investors are still predominant in CEE, their share in imports and FDI inflows is continually shrinking. Imports from EU-CEE11 and China are sharply increasing, in FDI more investors come from the region itself and Asia (e.g. South Korea). The shift to e-commerce during the pandemic offers opportunities for the entry of new competitors.

National-populist politics: The region experienced a rise of nationalism in recent years and an erosion of democratic rules. Politics have not affected the CEE economies negatively yet – the FDI inflow remained constant since 2016 at about € 35 bn. Unfortunately, the crisis plays in favor of autocratic regimes as the lockdown and insecurity of people allows them to grab more power and strengthen their position. In the aftermath of the global financial crisis foreign multinationals can be easily made scapegoats for negative effects again and will be very likely prime targets when it comes to footing the recovery bill .

Management has to pay more attention to economic and political affairs in CEE

Decline in institutional quality: The EU-CEE11 countries in Southeastern and Central Europe were already lagging behind Western Europe in regulatory quality, rule of law and fighting of corruption before the outbreak of Covid-19. The Baltics, Czech Republic and Slovenia show the highest level in institutional quality in the region. At the same time, we could observe a decline even in econo-mically advanced countries such as Hungary, Slovakia and Slovenia. One cannot expect that prevalent anti-democratic and protectionist developments as well as corrupt practices will disappear in post-pandemic times.

Transition to knowledge economy: Further increases in national wealth requires the transition from the prevalent low-cost model to an innovation-driven economy. The pandemic highlights the need for an accelerated digital transformation. Industry 4.0 will benefit from a better digital infrastructure as well as digital business services, a strength area of the CEE economies. However, the brain drain and lack of IT skills in the workforce will slow down a fast digitalization.

European/global developments: An further escalation of the EU-US trade conflict would hurt Central European economies via global supply chains of foreign (German) manufacturers. At the same time, new FDI from Asia and North America due to the regionalization of value chains would mean more competition for labor and public funds for the incumbents. In the next long-term EU budget 2021-27 cuts are intended for CEE countries what would negatively affect the financial support for local investments and construction projects of foreign multinationals.

Overall, **incumbent Western multinationals** should not expect an improvement of the business and **investment climate** in post-coronavirus times. They will face a stronger and more demanding state, intensified competition from within the region and from overseas. The labor and skills shortage is just postponed.

The management will have to pay more attention to the economic and political **affairs in the individual countries**, upgrade **regional management** competencies in their organizations and consider the more comprehensive use of **political strategies** to protect the sustainability of their local businesses in CEE.

Agenda

1. Introduction
2. Aims of the study and methodology
3. Major business challenges in CEE in pre-Covid-19 times
4. Overview of the impact of the Covid-19 pandemic
5. Impact of Covid-19 on CEE business challenges
6. Conclusion

Renewed interest in the activities of foreign multinationals in CEE as a starting point

Since the fall of the Iron Curtain 30 years ago, the CEE region has become an **attractive business destination** for Western multinational firms. Foreign direct investment has played an outstanding role in the economic development of the region. Foreign firms acted as change agents and were drivers of the modernization of CEE industries.* While the expansion into the region in the 1990s and 2000s was a main topic of international business research, the interest faded after the global financial crisis. In the last years it seems that **business has become "normal"** in CEE, not very different from doing business in the western part of Europe.

With this study we want to shed light on **current business challenges** that Western MNCs face in the EU-CEE11 region: What is currently bothering the management of multinational firms in CEE? What local and regional developments are shaping business activities in CEE?

We started in November 2019 with a literature review, secondary research and talked to experts and company representatives. At the end of February 2020 the Covid-19 outbreak interrupted our research plan and led to a change in the direction of our project. We were still interested in the challenges but looked at them now through the lens of the Covid-19 pandemic.

*In 2017, 78% of the FDI stock in EU CEE-11 originated in the old EU-15 countries (wiiw, 2019c); Schuh (2017)

Defined aims of the study and an appropriate methodology ensure relevant results

The aims of the study are described by the following two thematic questions

1. What are the predominant **management challenges for Western MNCs in EU-CEE11** and how are MNCs affected by the challenges?

2. How does the **Covid-19 pandemic impact** the identified structural business challenges and the future attractiveness of EU-CEE11 for Western MNCs?

The methodology consists of the following four elements

Secondary research:
Analysis of articles, management reports, scientific papers, etc. about MNC's challenges in CEE and the impact of Covid-19

Visits to:
- Siemens Hungary
- Corvinus University of Budapest
- Deutsch-Ungarische Industrie und Handelskammer
- Advantage Austria Budapest
- Union VIG Insurance

Field Trip:
- Budapest in February 2020

Talks with company representatives:
- Henkel CEE
- Vienna Insurance Group
- Erste Group Bank
- Mondi Group
- Vienneast Consulting

These six business challenges keep the management on the run

Benefitting from higher growth rates and lower labor and production costs have always been major motives for coming to CEE. But the participation in those **emerging economies** came at a cost. The investors had to cope with abrupt up and downs of economies and markets, unpredictable politics and fast changing regulatory frameworks.

To identify current structural issues we reviewed **reports** from international organizations and think-tanks, discussed them and condensed them to the six main challenges listed below. They result from distinctive developments in the **local business environments**, the stage in economic development and the country's position in global supply chains. These develop-ments affect the running of local operations, potential business expansion and performance.

Labor shortage and demographic decline

How does labor shortage and demo-graphy affect MNCs? Labor shortage and declining populations threaten the low-cost position and business expansion.

New competition

How did the competitive scene change in the last years? New local as well as foreign competitors from China want to gain a larger foothold in CEE markets.

Nationalist-populist politics

Do nationalistic tendencies in politics deter MNCs from investment? The combination of nationalistic tendencies and strong government is boding ill for foreign MNCs.

Institutional decline

How will the decline in institutional quality affect investment? Institutional quality is a decisive factor in FDI decisions and traditionally weak in CEE.

Move towards knowledge economy

How do MNCs benefit from the transition towards a knowledge economy? So far, CEE countries are mostly modest and moderate innovators.

Global developments

Which global developments and events can hit CEE hard? As small open economies, they are heavily dependent on foreign trade and investment.

References: Bertelsmann Stiftung (2020), Freedom House (2020a), IMF (2019), wiiw (2019c), How (2019), EBRD (2019a), McKinsey (2018)

Labor supply in CEE is used up, as companies report labor as limiting factor for production and labor costs increases

The strong GDP growth over the past years in CEE increased labor demand steadily, leading to **record low unemployment** rates in some countries. Companies, especially in Hungary, Poland and Bulgaria are constrained by the **lack of workforce** in their business output. The increased demand for the scarce resource of the rightly skilled workers also leads to massive wage increases between 4.2% (Slovenia) and 13.3% (Romania) between 2016 and 2019. The increase affects companies differently.

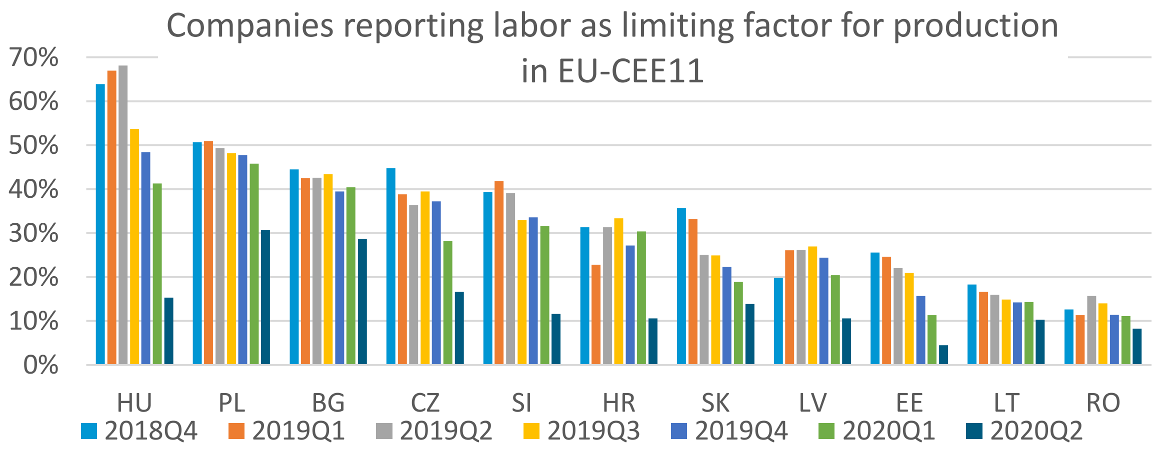
Consequences of the labor costs increase for foreign…

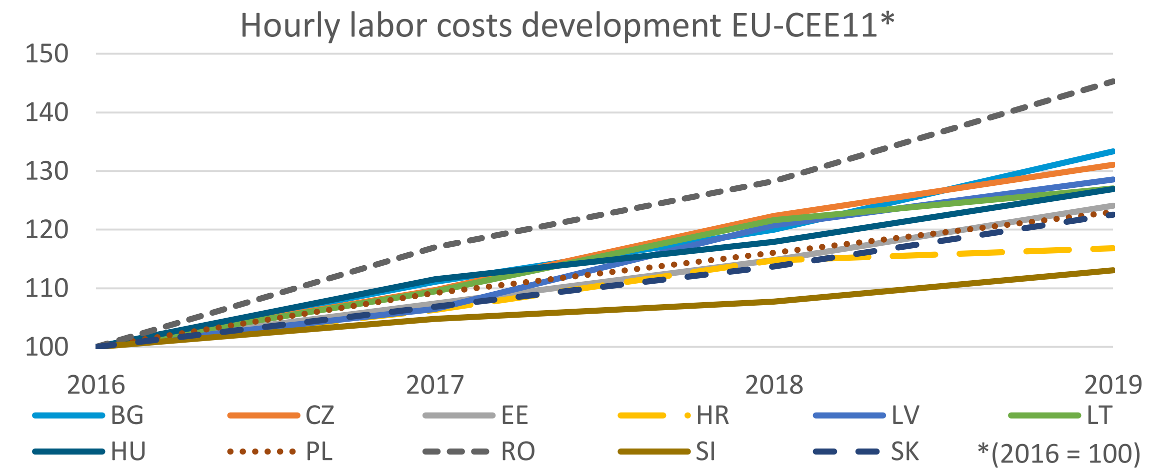
…production-oriented companies

- Drastic wage increase in CEE
- Reduces the competitive advantage of low labor costs
- Limiting the further business expansion
- Discourage future investments in CEE
- Trying to establish less labor-intensive tasks or switch to automation

…market-oriented companies

- Overall beneficial trend as purchase power increase leads to larger market
- Domestic demand increases and reduces the impact of external economic shocks
- Increased wages for local staff play a minor role





References: Eurostat (2020b), Eurostat (2020a), wiiw (2019b)

The labor shortage in CEE is caused by many factors, but mostly due to a declining workforce

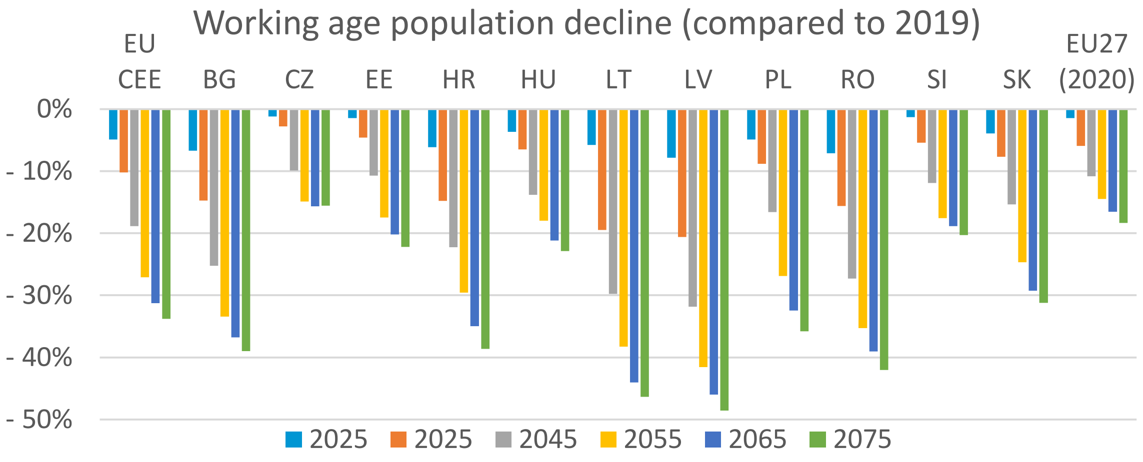
Two main trends drive labor shortage: the overall **declining population** and workforce and the **skills mismatch**, namely workers not having the skills needed on the labor market. Both aspects are rather structural issues and affect all EU CEE 11 countries, however, Czechia is projected to do comparatively well, whereas the Baltic States are hit extremely hard.

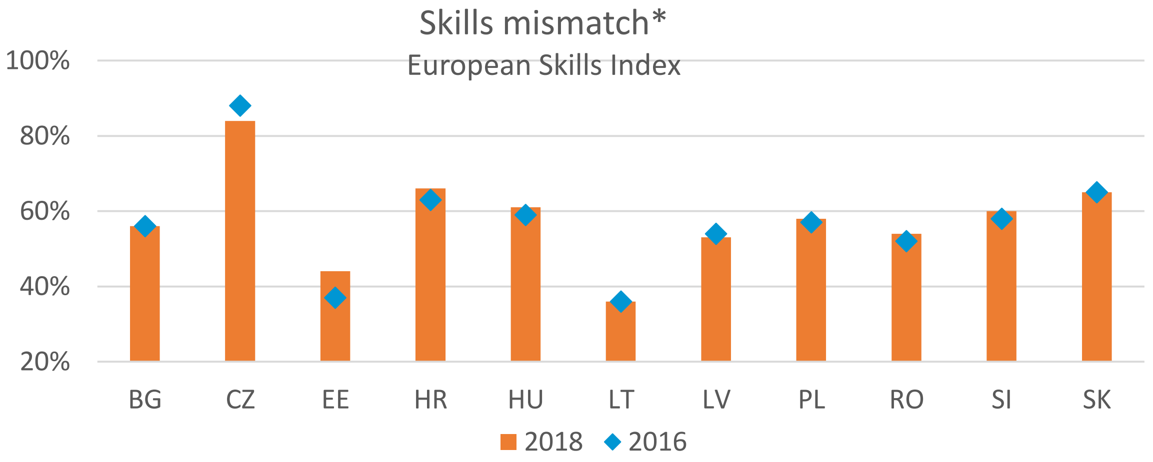
Reasons for the workforce decline

Overall declining and aging population
- Migration to western Europe in search of better pay and living conditions
- Working in Western Europe on short term contracts
- Low fertility rates
- Strict limits on immigration from outside the EU

Skills mismatch
- Companies cannot find rightly skilled employees

Above EU average economic growth in the past years
- Higher growth and low production costs have led to strong FDI inflows from abroad
- Still extended workbench as part of the "German value chain"

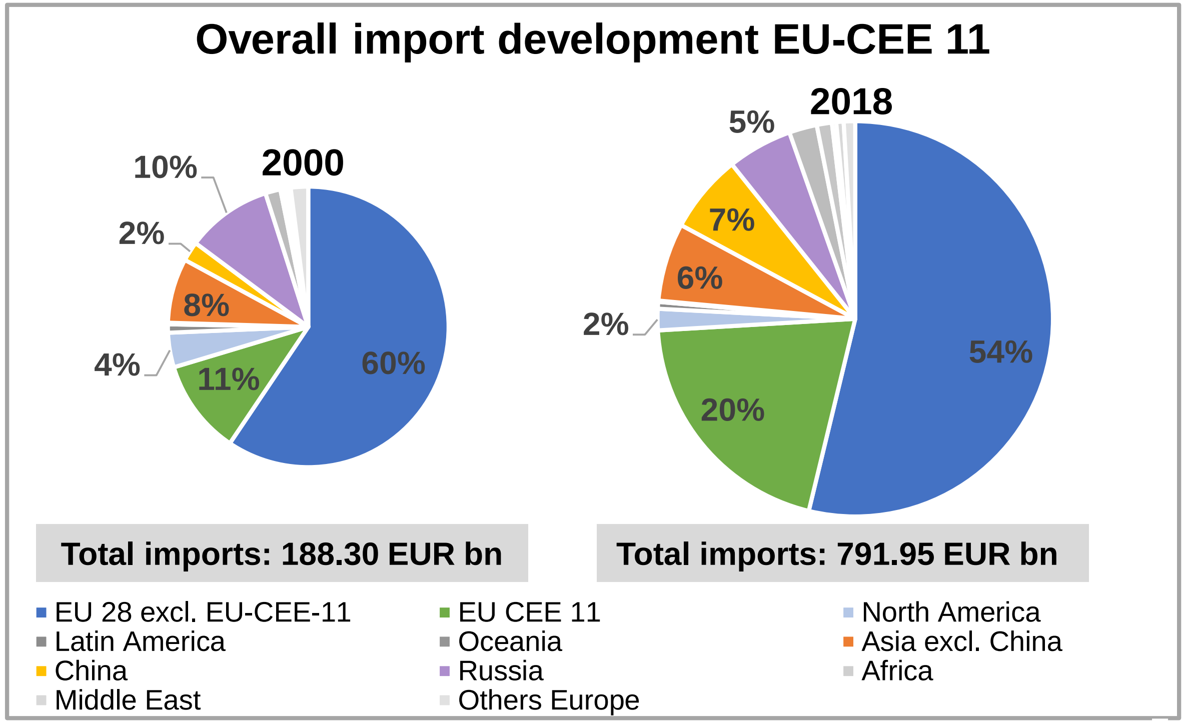


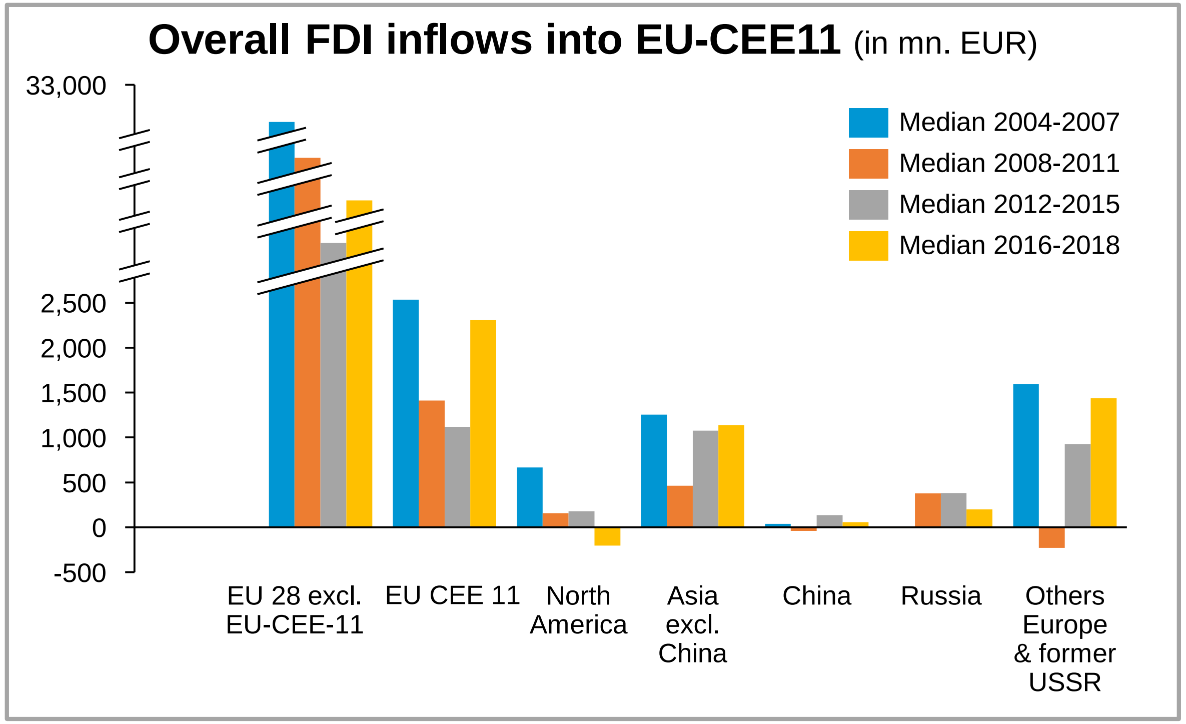


References: Esipova & Ray (2017), Cedefop & DG EMPL (2020), Eurostat (2020c), Shotter (2018), wiiw (2019b) *The European Skills Index is Cedefop's composite indicator measuring the performance of EU skills systems. The ESI measures countries' "distance to the ideal" performance. This ideal performance is chosen as the highest achieved by any country over a period of 7 years. A score of 84% in the case of Czech Republic suggests that the country has reached 84% of the ideal performance.

The "old EU 15" remain the leading source of imports and FDIs in EU-CEE11, but the share of intra-EU-CEE11 trade is constantly rising

From 2000 to 2018, imports to the EU-CEE11 region more than quadrupled. This development is illustrative for the CEE region's rising purchasing power and its growing market attractiveness. Despite the **declining share of EU 28** (excl. EU CEE 11) **imports**, the former remains **the main source of imports**. Furthermore, we see three distinct trends: **declining share of Russian imports**, **growth of intra-EU-CEE11 trade** and an **increasing share of Chinese imports**. When it comes to FDI inflows in EU-CEE11, the total values do not indicate a clear overall trend. However, what can be observed is that **EU 28** (excl. EU-CEE11) remains the **major investor** in the region. Investments from North America are slumping. Russian FDIs are medium-sized and fluctuate strongly. A **considerable share** of FDI comes from **Asian countries** (e.g. South Korea).





References: wiiw (2020b)

A variety of spotlights confirm EU-CEE11's market and investment attractiveness – and it lures new investors

As the following **industry spotlights** show, the CEE region remains a **highly attractive investment destination and market** for foreign multinational companies. Furthermore, the examples indicate that new investors and importers are gaining importance – being illustrative for the geographic diversification.

Import spotlight of EU-CEE11

Poland: declining Russian imports...

- In 2012, Russia was the 2nd largest import partner of Poland, since then Russian imports were falling strongly
- Major imports: mineral fuels, gas
- Poland aims to reduce dependence on Russian energy sources and threatened to stop imports

... while Chinese imports explode

- 2nd largest source of imports - primarily electronics, machinery & toys
- Economic cooperation with China expected to grow further due to Belt and Road Initiative

Shipping containers with import goods

Samsung's planned Gigafactory in Hungary

FDI inflow spotlights towards EU-CEE11

Hungary: A springboard for South Korea

- Hungary is the 2nd most attractive FDI destination in EU-CEE11 following Poland
  - Lowest corporate tax rate in Europe (9%)
  - Springboard to Eastern & Western Europe
- Main FDI target sectors: manufacturing, wholesale & retail trade, repair of vehicles
- In 2019, South Korea has become the largest investor, accounting for 48% of the country's total inward FDI (EUR 5.2bn)
  - Samsung announced a EUR 1.2bn investment in the construction of one of the largest e-vehicle battery plants globally

References: bne IntelliNews (2019), China Daily (2020), Emerging Europe (2019), EY (2020), Pulse (2019), Santander (2020), TRADING ECONOMICS (n.d.)

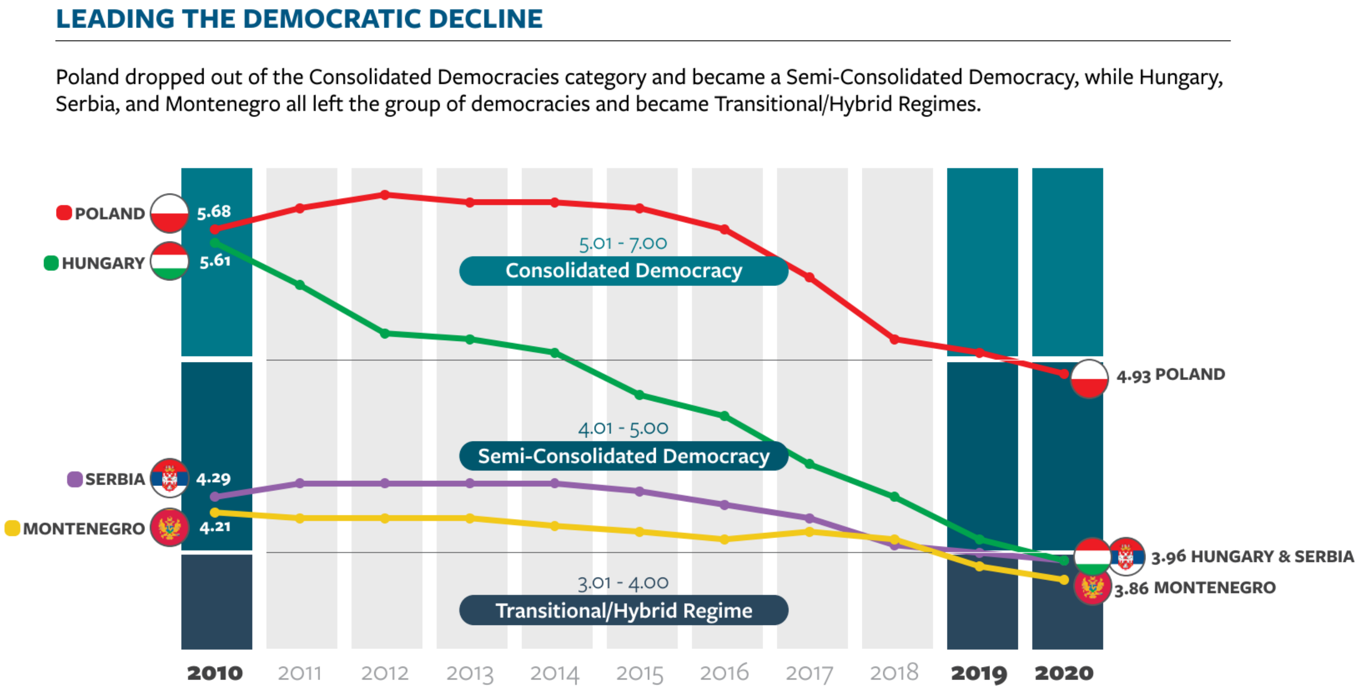
Despite increasing political tensions in CEE countries, they did not impact the FDI flow yet

CEE countries experienced a wave of **rising nationalism**. As well as in other European countries, right-wing parties gained popularity. Despite the numerous benefits that EU membership brings to CEE economies, they were becoming more and more “Eurosceptic:” according to the latest Eurobarometer results, the Czech Republic is the third most Eurosceptic member of the community.

Although the political risk has risen in the last decade – mostly in Hungary –, the CEE region before Covid-19 was **much less risky** than other emerging regional markets.

Political issues have yet to negatively impact CEE economies and businesses. The inflow of foreign investments **remains positive**, due to the location, cheap and qualified labor, and low corporate taxes, and several large investments are conducted in the region. According to wiiw FDI Report, in 2019 the annual inflow of investments has been about €35 bn. since 2016.

However, any possible further deterioration in terms of **political risk** could make foreign entities reluctant to remain in CEE countries, especially if it would hurt them directly. Due to a significant cooperation with the public sector using EU co-financing, construction and ICT would be the first sectors hit.

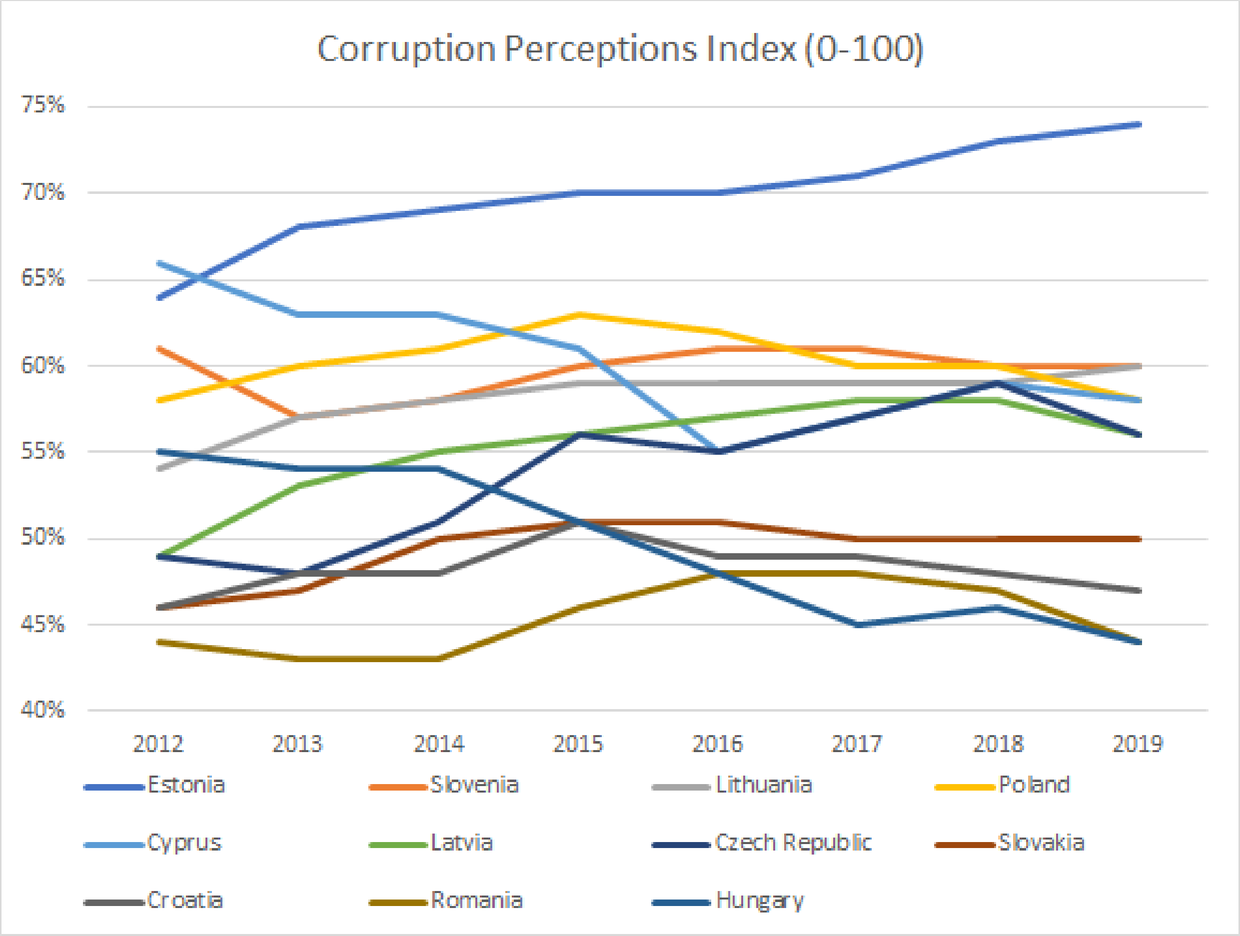


Corruption remains an unsolved issue for many of the CEE countries

Corruption issues continue to play a role in the CEE region's political risk, despite countries adopting to EU standards and making crucial improvements in this field, including setting up anti-bribery watchdogs in many countries.

Although CEE countries have made **huge improvements** in terms of corruption, it remains prevalent: Bulgaria, Hungary, and Romania are placed last among European countries in Transparency International's corruption index.

Corruption is directly influencing **FDI flows**. Especially it can be seen in the sectors, where the government plays a significant role, forcing companies to "follow the rules," like frauded tendering process. Western MNCs confronted with tightening **compliance standards** do not want to be involved in such situations as **scandals** can easily taint their reputation in the host country but also at home.



References: Transparency International (2019)

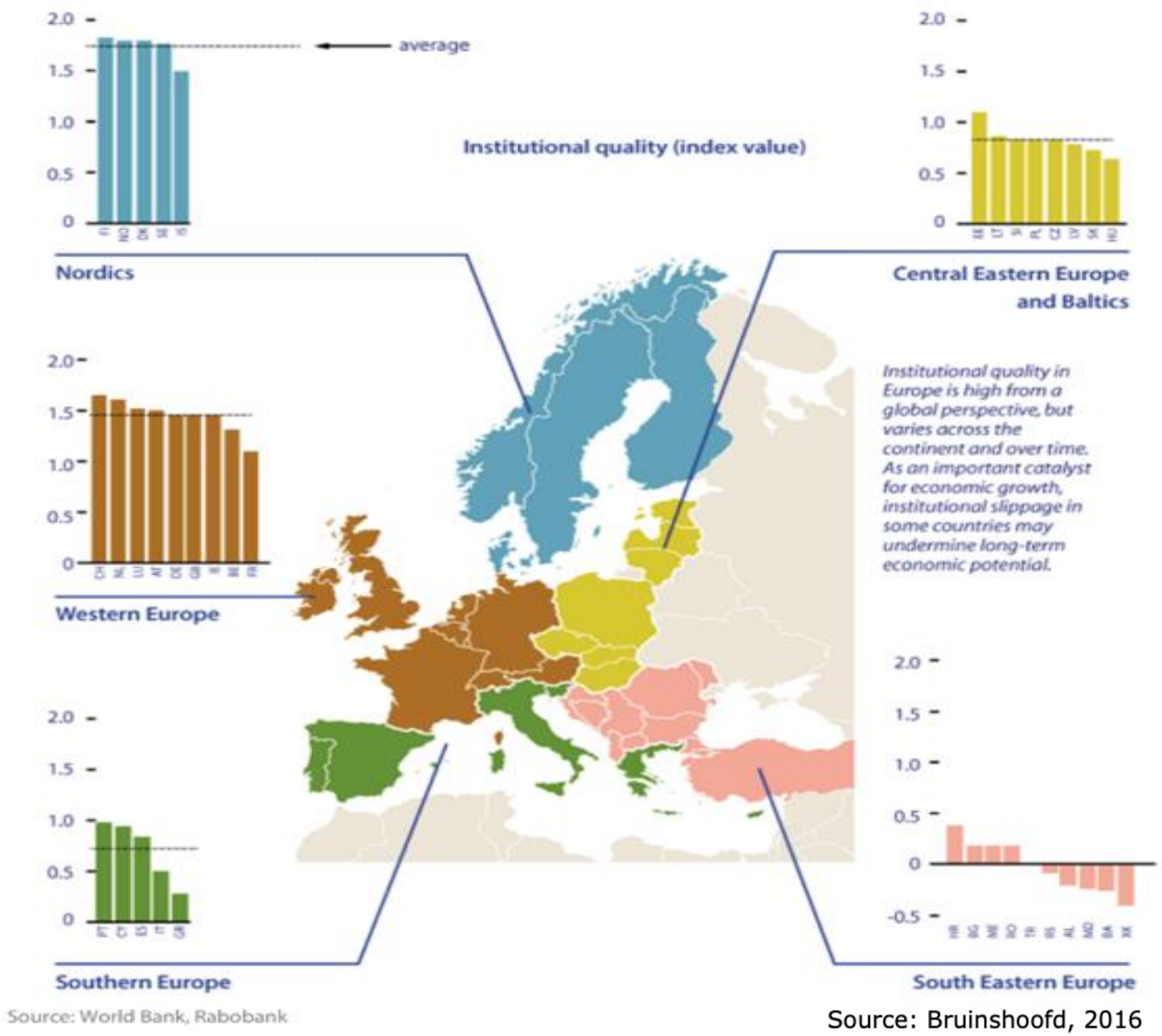
Institutions in CEE are still lagging Western Europe – changing them for the better offers quick wins for the economy

The size and growth potential of markets as well as strong institutions and investor-friendly regulations are **key criteria** for FDI decisions.

When comparing European regions, Western Europe and Nordic countries have been faring better than **Central Eastern Europe** and **Southeastern Europe** in terms of institutional quality.

Positively seen, the CEE sub-regions offer still a high potential to attract more FDI by improving rule of law and the effectiveness of government regulations and services. Institutional quality is seen as an important **catalyst for economic growth**. Another advantage is that laws and regulations can be changed quickly and so offer the opportunity for quick wins, however, also for political manipulations.

When CEE governments want to achieve a higher level of economic development and attract more FDI, they have to bring their laws and "rules of the game" in line with the standards of developed countries. Good governance even matters more for **innovation-led growth**.



Source: Bruinshoofd, 2016

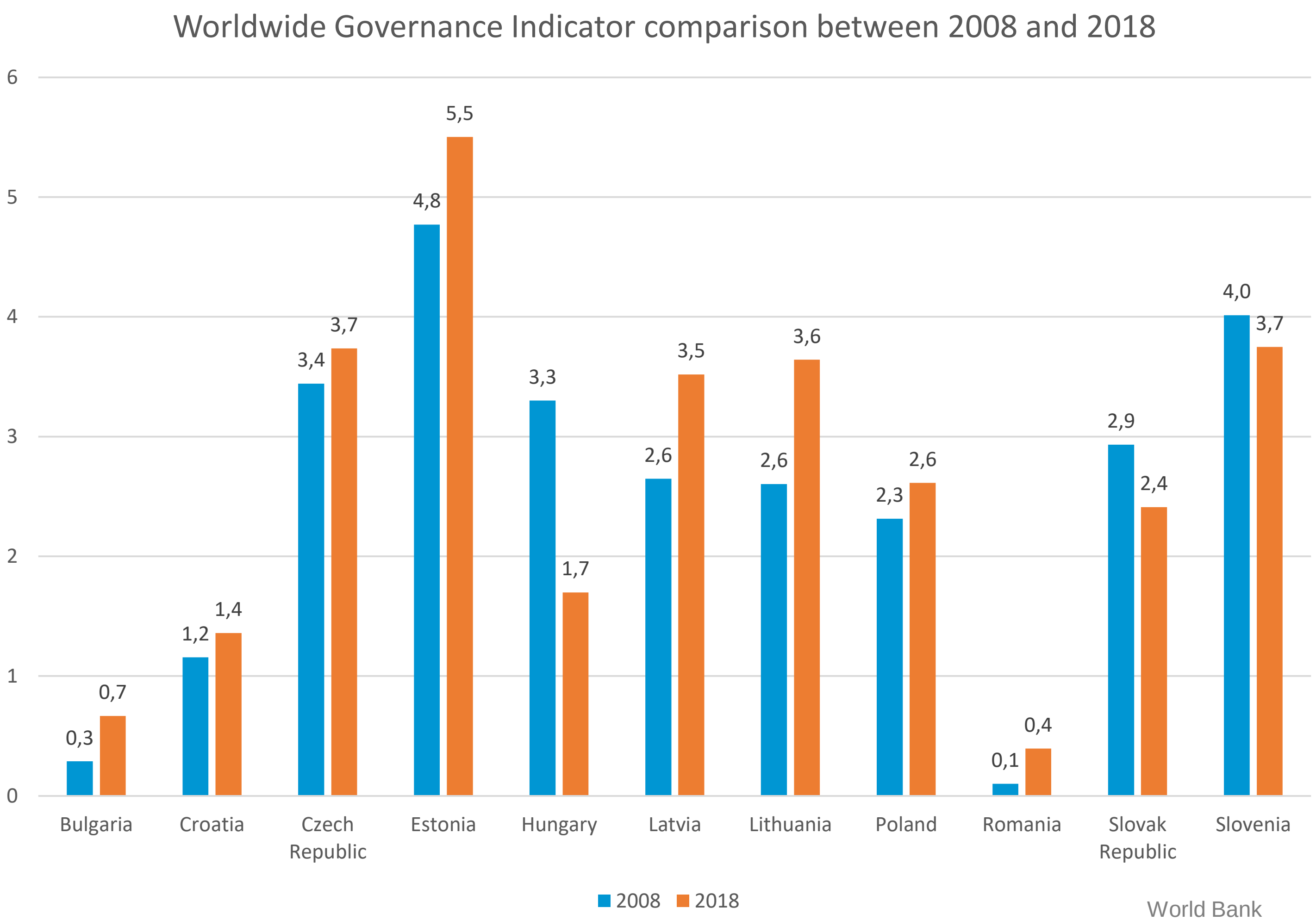
References: Bruinshoofd (2016), Hornberger, Battat & Kusek (2011), EBRD (2019a)

The quality of institutions still differs markedly among the EU-CEE 11 countries

The **Baltics**, **Czech Republic** and **Slovenia** show the **highest level** in the quality of institutions. Except for Slovenia they also improved markedly their performance from 2008 to 2018. In contrast, Southeast European countries do poorly.

Unfortunately, the quality of institutions in the economically advanced countries Hungary, Slovakia and Slovenia even **declined** in this period.

This **decline** stems from a weakening voice and accountability, regulatory quality, rule of law and control of corruption. **Reasons** for this deterioration can be found in an increasing political trend towards nationalist-populist governments and autocratic methods ("Illiberal democracy"). The fightback against those trends only shows slight progress.



World Bank

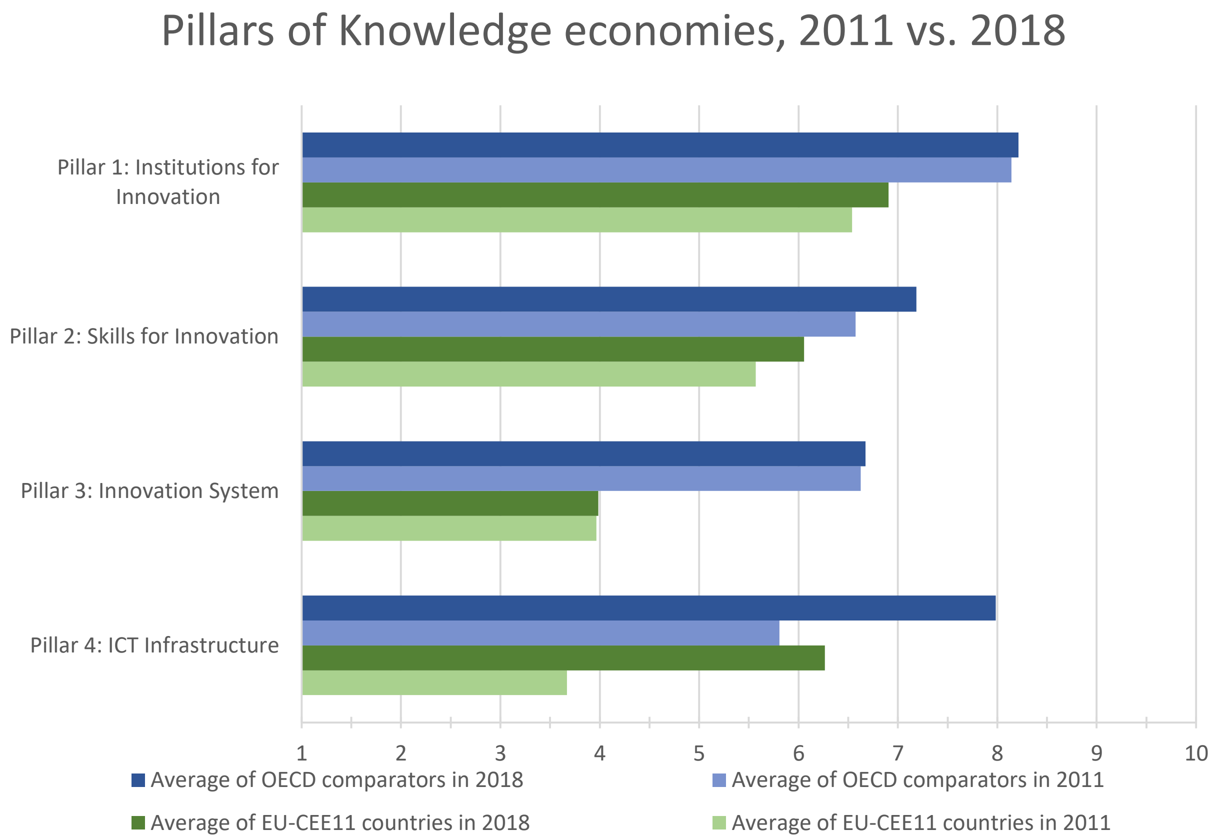
References: wiiw (2019c), World Bank (n.d.)

CEE region is in the middle of a transition phase towards a knowledge economy

The **“knowledge economy” (KE) index** is a concept of economic development, in which innovation and access to information drive productivity growth. Starting from different levels, the KE index has grown for all CEE countries bringing them closer towards a knowledge economy.

- **Early KE**: has weak institutions and skills for innovation, together with poor ICT infrastructure (Bosnia and Herzegovina, Kosovo, Ukraine)
- **Intermediate KE:** has somewhat stronger institutions for innovation and better ICT infrastructure, but still relatively weak skills for innovation (**Bulgaria**, Moldova, **Romania**)
- **Advanced KE:** has relatively favorable institutions for innovation and ICT infrastructure (**Estonia**, **Hungary**, **Latvia**, **Lithuania**, **Poland**, **Slovakia**, **Slovenia, Czech Republic, Croatia**)

EU-CEE11 countries improved in every category, with the **ICT infrastructure** experiencing the greatest boost. The biggest gap between OECD comparators and EU-CEE11 economies is the **innovation system**, as knowledge economy depends heavily on major innovation players, their resources and interactions, e.g. R&D. Skills for innovation improved over the years and in combination with favorable labor costs the EU-CEE11 economies are an attractive target for FDIs supporting the shift to knowledge economies.



References: EBRD (2019b)

The continuously improving digital environment attracts many MNCs to invest in the region

Governments of CEE countries encourage investments in **digital transformation** and R&D via a variety of incentives, including tax breaks, investment subsidies, streamlined bureaucratic processes, and funding for training partnerships with universities.

Software-based development

- In May 2020, Microsoft Corp. announced a $1 billion investment in the **"Polish Digital Valley"** with a strong focus on upskilling local talent with the latest cloud-based competencies to empower local organizations to accelerate and drive their digital transformation, support employment opportunities in market and increase competitiveness.
- Microsoft and Chmura Krajowa ("national cloud," initiated by one of Poland's largest banks PKO and the Polish Development Fund PFR) have signed a **partnership agreement** to support Polish public institutions and businesses in critical sectors such as government, health, education, manufacturing, retail, energy, finance, insurance and more.

Production-based development

- Hungary evolved to a **hotspot for the automotive industry** in Europe with several production facilities and R&D departments. Besides car manufacturers Audi and Mercedes-Benz, also producers for car parts are present in the country, e.g. Bosch, Knorr-Bremse and Continental.
- Strong support from the government: "Zalazone Test Track" for testing autonomous vehicles. Complete track with features like a high-speed track, city simulation, noise measurement.
- Partnerships with universities by offering masters programs like "Autonomous Vehicle Control MSc" and "Autonomous Vehicle Programming MSc".

References: HIPA (2018), McKinsey (2020), Microsoft (2020), POLAND IN (2019)

Geo-political and EU developments pose threats to the economic development of CEE

We identified **three structural challenges** resulting from geo-politics and geo-economics that pose **a significant threat** to CEE economies:

- An **intensifying US-EU trade war** would hurt those CEE economies and industries that are connected via **supply chains** directly or indirectly through German exports to the US market.
- **Reduced EU funding** directed to the CEE in the next budget period would hit former beneficiaries such as Poland and Hungary hard and finally multinationals operating there.
- The great **dependence** of CEE economies on Germany as **a trade and investment partner** might impose risks for the region's economic development.

US-EU trade war

So far, the US administration has suspended its plan to further tax European imports. An escalation into a trade war would also hit CEE economies hard due to their **dependency** on the German supply chain. Therefore, the US-EU trade war poses a key risk to CEE.

The US-EU trade war may force global players to **shift their supply chains** and adapt pricing strategies. The **automotive industry may suffer** the most due to imposing higher tariffs on European cars.

Fewer funds in next EU budget round

A smaller post-Brexit EU budget is **highly likely**. Reductions would cut into the Cohesion Fund and the Common Agricultural Policy (CAP) as the funding priorities change. CEE countries will fight this reduction and **end up with smaller cuts** than expected in this political bargaining process.

Western multinationals will follow this process closely as they benefit in many sectors (e.g., construction, military industry) **indirectly** via **public tenders** and **state subsidies**. National-populist governments can use this reduction of EU funds to fuel their **anti-EU propaganda.**

Dependence on German Supply Chain

German firms use CEE locations as an "extended workbench" in their global value chains. There is a **risk of dependence** on homogeneous production structures, and failure to develop service sectors. Also, Germany's role as a **hub for CEE exports** to foreign markets has increased. To leverage its position in the SC and to broaden the range of export countries, MNCs in the Baltic States should focus on their **competencies in the service sector**, while MNCs in the Czech Republic, Hungary and Slovakia on **manufacturing industrial products**.

References: Kordalska & Olczyk (2019), Bertelsmann Stiftung (2018), EURACTIV (2018), Noah (2018), Popławski (2016), Reuters (2020)

Despite a satisfying economic growth in CEE, some risks are looming at the horizon

In the last years, the EU-CEE11 economies were back on the **catching-up path**, outperforming their western peers in growth rates again. While **infrastructure** and **operational environment** were considered satisfactory by foreign investors, the **formerly good view** on the labor markets was deteriorating due to **labor shortage** and **perceived threats** stemming from the political and regulatory framework were growing.

Categorizing the identified challenges in a matrix consisting of the **direction of a development** (positive/negative) and the possible **time of occurrence** (short- vs. long-term) results in the constellation depicted in the figure on the right.

We expected more **negative** pre-Covid-19 developments in the CEE business environment, especially regarding workforce shortage, more antagonistic government activities towards foreign investors and a further weakening of institutions. **Rising FDI and imports** can be interpreted in two ways: on the one hand, they can be seen as an **increase in competition**, particularly from companies from CEE, China and Asia. On the other hand, they might mirror **a high attractiveness of CEE** for new investors (and maybe investors in general).

Among the **short-term risks** are a potential trade war between EU and USA as well as reduced EU funds for the region in the next EU budget 2021-27.

On **a positive note**, we would like to point out **the strong position of CEE** as location in global supply chains and the taken and planned efforts by governments to drive forward the **transformation to an innovation-driven economy**.

Impact of challenges on the attractiveness of the CEE region to investors

	Negative	Positive
Long-term	• National-populist politics • Labor shortage • Weak quality of institutions • Rising FDI and imports	• Strong position of CEE in global supply chains • Efforts regarding digital transformation
Short-term	• Worsening US–EU trade relations • Reduced post-Brexit EU budget	• Good economic development

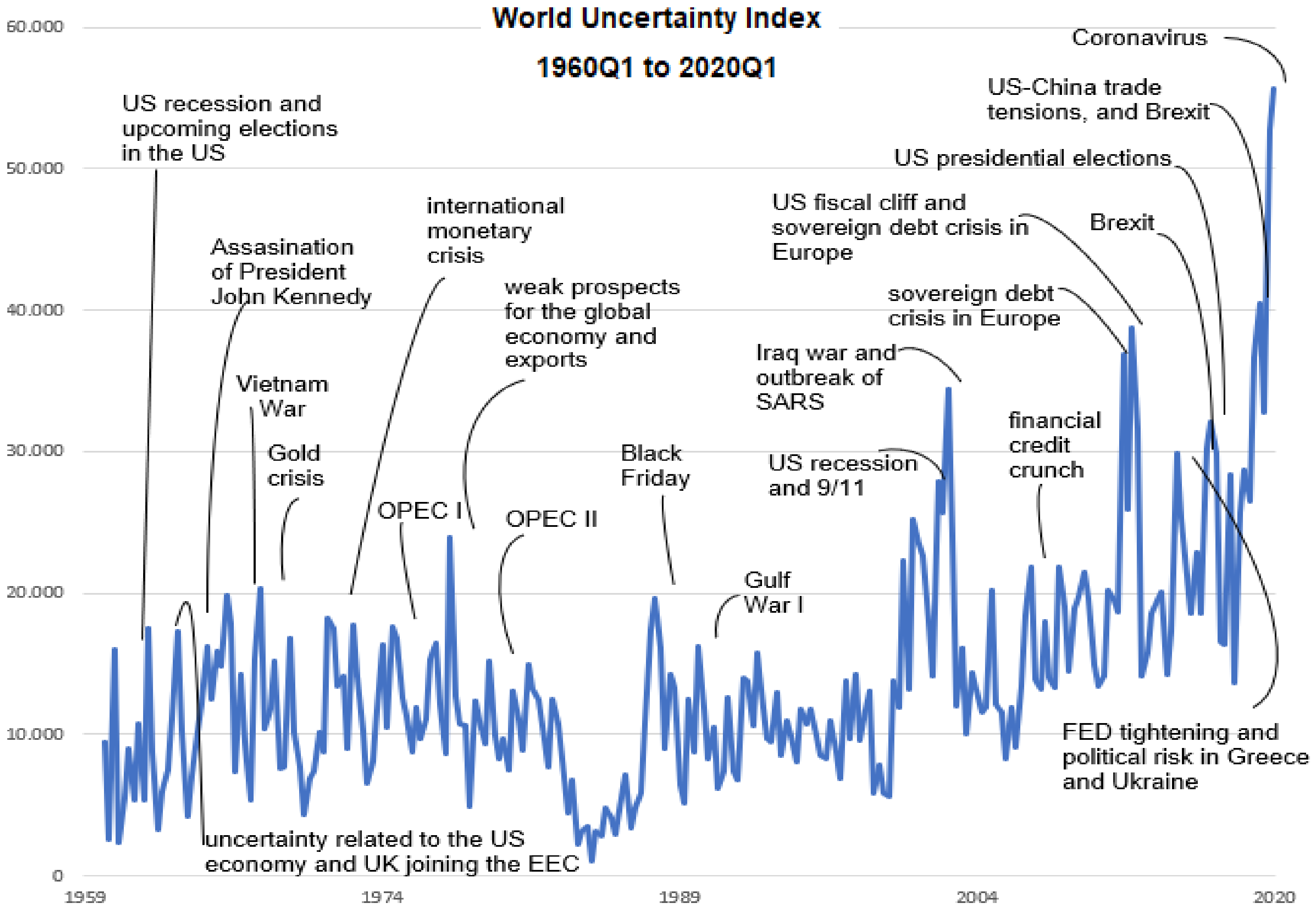
References: EURACTIV (2018), wiiw (2019a), Wölfer (2018)

Pandemic led to a dramatic spike in worldwide uncertainty, adding up to existing problems

The high speed of spreading combined with the **severity** and **global reach** of the disease categorize Covid-19 as a pandemic.

The Covid-19 pandemic is exerting a more radical and abrupt effect than any other crisis – it is a combination of a **public health crisis**, **international supply chain interruption** and **demand collapse**. Its newness and complexity makes it hard to handle what increases the uncertainty for policy makers and companies to unprecedented heights.

The IMF expects the **worst recession** since 1929's Great Depression with a decline of global GDP by –3%. The recession will be followed by an economic and social crisis on a global level - up to 100 million people worldwide could be pushed into extreme poverty.

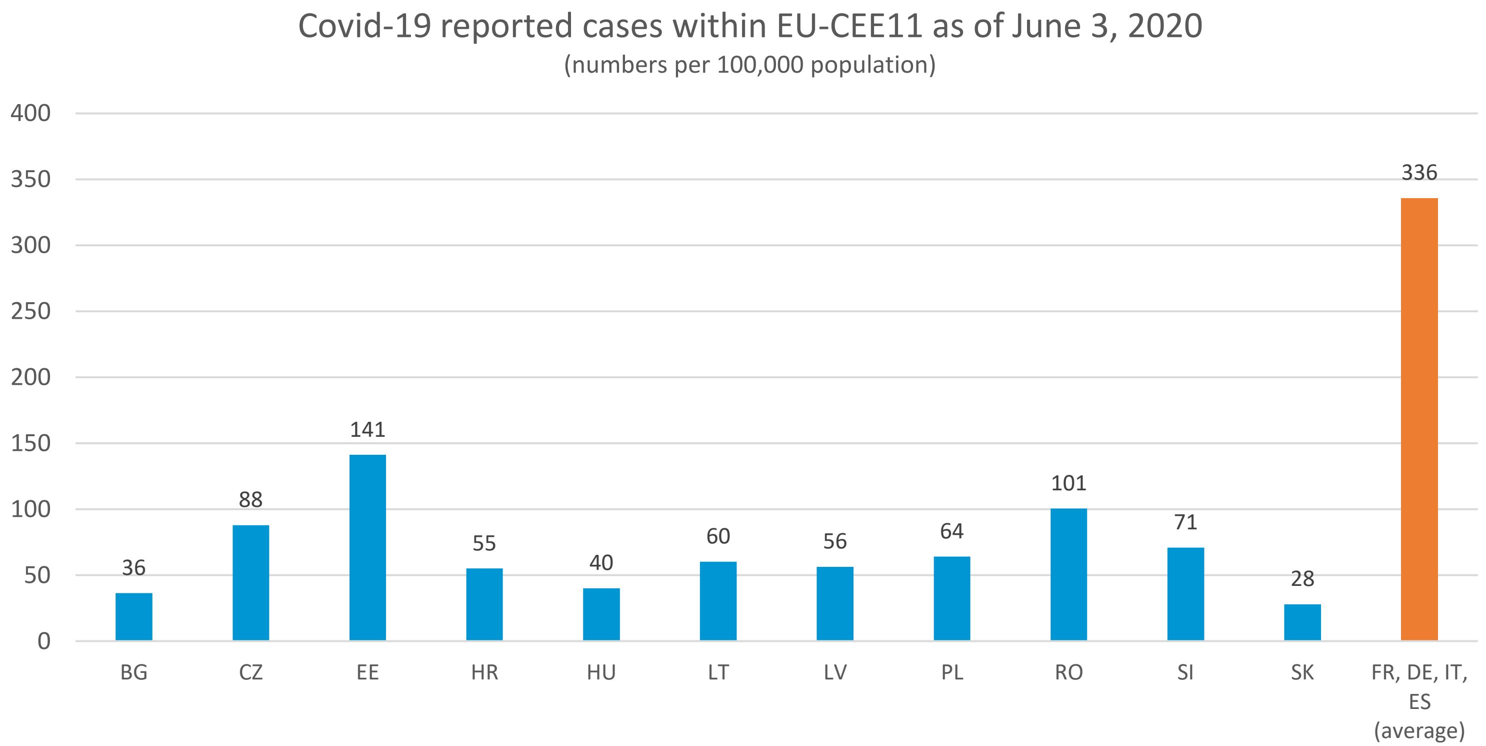


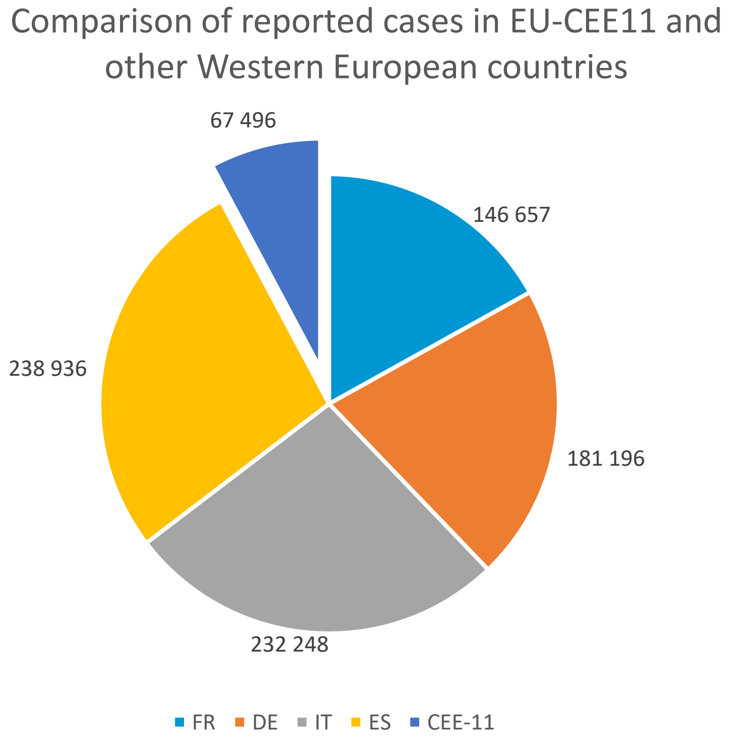
References: Ahir, Bloom & Furceri (2018), IMF (2020), World Uncertainty Index (2020)

While CEE is not always a region boosting with good examples, this time it’s different

The number of **cumulated cases in EU-CEE11 are much lower** than those of the most impacted EU Member States in the West. Several reasons for this can be pointed out:

- **early lockdown measures** implemented by almost all countries in the region
- fear of underfunded and struggling **healthcare systems being quickly overwhelmed** helped with decisiveness
- vulnerability of healthcare systems made **populations more willing to follow** the orders





References: The Guardian (2020), WHO (2020)

The whole EU faces a downturn, but the EU-CEE11 economies are especially fragile

The EU-CEE11 countries are expected to experience the **biggest recession since the global financial crisis** or potentially even worse developments. As of late March, the whole CESEE region is estimated to **contract on average by 3-5%**

Slovenia and the **Baltics** will be the hardest hit due to the strict containment measures which included a massive shutdown in businesses and schools

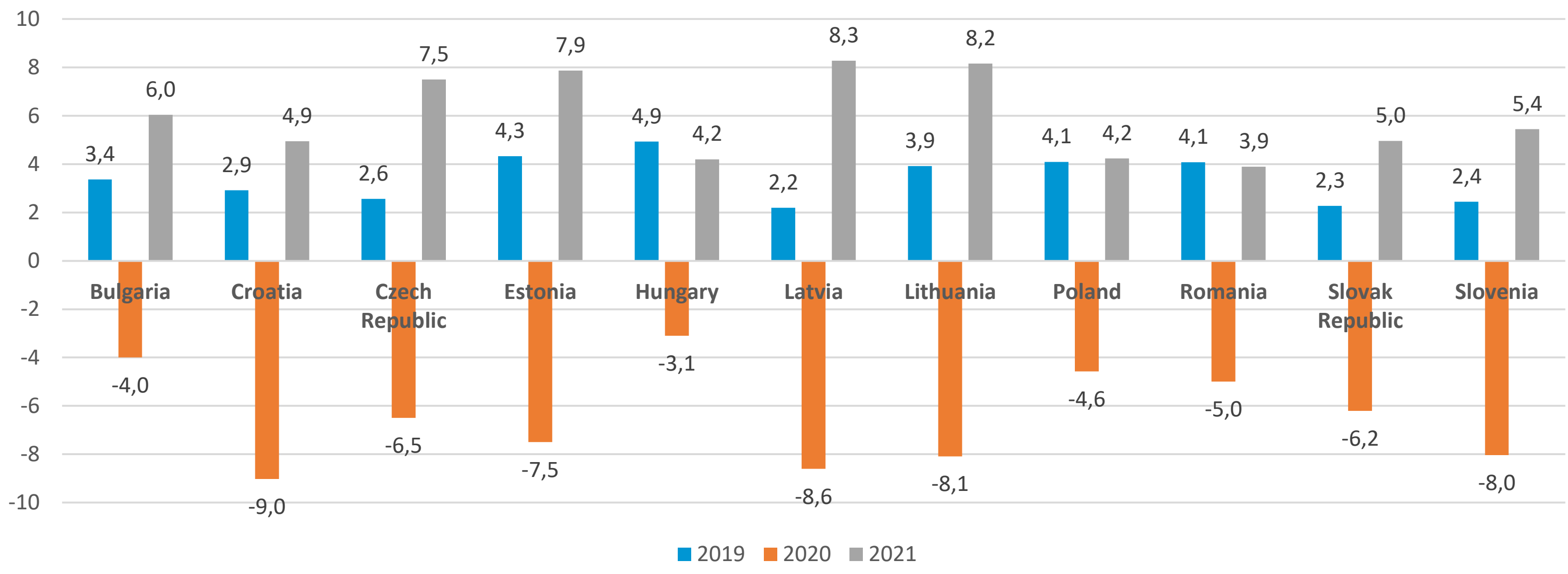
Croatia, Latvia and **Lithuania** will face the biggest falls in the region, mainly due to the disruption of tourism-related activities.

Poland is less affected due to its larger domestic market and lower international trade exposure

Western European economies are also expected to be hit considerably by the pandemic, with Germany, France and the Netherlands estimated to average –7.0% in GDP for 2020

Comparison of changes in GDP for EU-CEE11 before, during and after the pandemic

(IMF estimates April 2020)



According to the wiiw, the **individual impact will be determined by the following factors**:

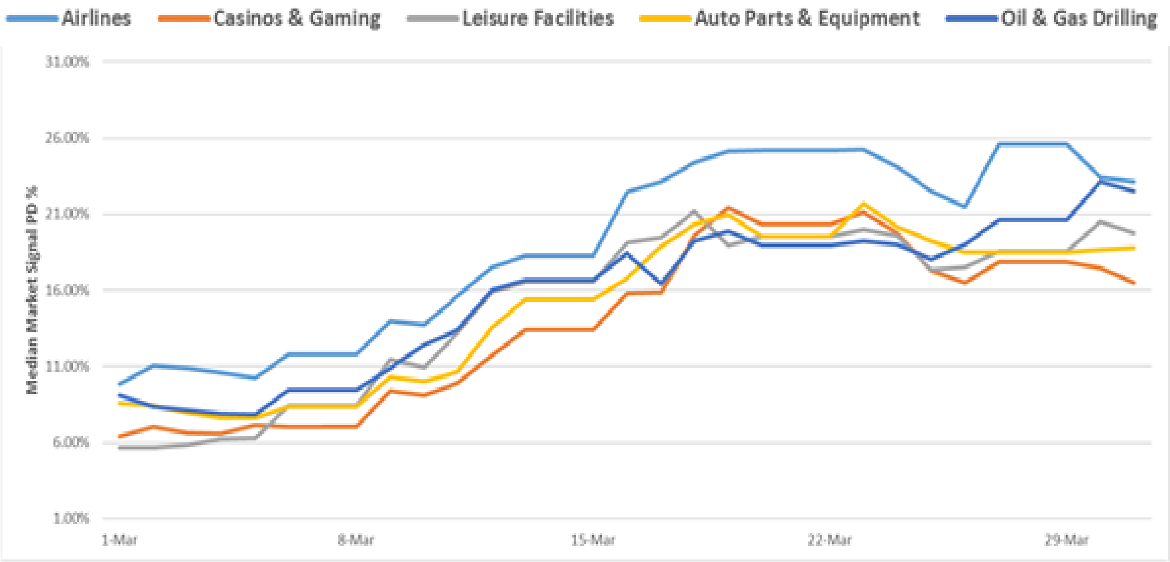
- **public healthcare status** (general state of healthcare system and ability to manage public health crisis will determine outcome)
- **fiscal implications** (central banks will provide extra financing, but foreign investors might lose confidence; furthermore, IMF support comes with stringent conditions)
- **macroeconomic implications** (trade openness being hit by disruption in global trade or tourism dependence of the economy)

References: wiiw (2020a), IMF (2020)

Number of industries are severely impacted by Covid-19, especially automotive industry

The most affected **industries** in the world are: Airline industry, Oil & Gas, Leisure Facilities, Auto Parts & Equipment and Casinos & Gambling.
Based on this data and level of foreign presence in some of industries, manufacturing sector will be harmed severe in CEE.
The impact on **automotive industry** is severe, disrupting the whole supply chain of major auto concerns.
SMEs are also greatly affected in CEE countries, depending on the level of support from government and restrictive measures.

Industries Most Impacted by Covid-19 from a Probability of Default Perspective March 2020



Impact on Automotive Industry due to Covid-19 by Countries

Country	Employees affected	Production lost in units
Czech Republic	45,000	143,981
Slovakia	20,000	100,673
Romania	20,000	68,673
Hungary	30,000	47,317
Poland	17,284	45,380
Slovenia	2,890	19,399
Croatia	700	-
Austria	14,307	16,865
Germany	568,518	553,767
TOTAL (EU + UK)	1,138,536	2,068,832

References: ACEA (2020), S&P Global (2020)

The identified challenges in the region will remain issues multinationals have to deal with in post-Covid-19 times

After the Covid-19 outbreak we **changed course** in our analysis. Instead of further deepening our research in the identified challenges for Western multinationals in CEE we discussed the potential impact that the Covid-19 pandemic might have on those structural issues. Based on internal discussions, talks with experts and a literature review on the projected impact of the pandemic, we made **"informed guesses"** on the effects on the identified six business challenges.

The pre-Covid-19 overview		Changes caused by the impact of Covid-19
✓ Find structural developments in the CEE business environment ✓ Indicate directions and impact on Western direct investors ✓ Prepare the ground for further analysis	→	✓ Project a strengthening or lessening of the developments (increase/decrease) through the assessment of the Covid-19-related effects ✓ Assess impacts based on their short/long-term effect

Since the Covid-19 has taken a hold of the global economy, we have set out its impacts we anticipate over either **short- or long-term**, recognizing it is not only an economic but also a social and political crisis. Some aspects will need to be fundamentally reconsidered by the management of multinational firms and their stakeholders in the light of new governmental regulations, cooperation among nations, and institutional changes. Such shifts lead to **mid- to long-term** effects.

Additionally, we do not expect any new challenges appearing due to Covid-19 – so **no new challenge** is added to the list in the post-Covid-19 phase. However, the previously described challenges are anticipated to be influenced by the recent crisis. The extent of the impact of introduced challenges might vary by country and industry depending on factors enclosed in the following sections.

Covid-19 is a short-term relief for CEE, but the structural issues remain unchanged

Due to Covid-19 crisis the unemployment rates rose significantly all over the world as well as in CEE. Companies are trying to cut costs in order to survive the crisis. They laid off employees or used government sponsored short-time working schemes. As a result the demand for labor plunged.

Short-term

+ **Demand for labor declines**
  - Countries face increasing unemployment rates
+ **Recession**
  - Recession in Western Europe (Germany) is hitting the demand for production in CEE
+ **Migration**
  - People migrating back home from Western Europe, as the job situation in Western Europe worsened

Medium to long-term

– **With the economic recovery, demand for labor should pick up**
  - As unemployment rates decreases, labor shortage becomes an issue again
  - Migration towards Western Europe will increase again
  - Skills shortage will remain an issue

– **Structural challenges remain unsolved**
  - Declining population due to migration and low birth rates
  - Aging population leads to productivity decrease
  - Workforce participation will remain low

Even though the Covid-19 seems to have “solved” the labor shortage, this is just a short-term effect, the structural problems remain. As soon as the economy recovers the labor shortage issue will appear again and will pose a threat to attracting new foreign investors and the expansion of existing capacities.

References: Coface (2017), Erste Group (2020), European Commission (2020), Trykozko (2020), UniCredit Research (2020)

An increase in competition can be expected, particularly in the medium- to long-term, as the CEE region becomes more attractive to foreign investors

The supply shock caused by the Covid-19 pandemic has highlighted the dependency of many MNCs on far away markets, causing a rethinking of global supply chains in light of further potential disruptions in the future. CEE as the European low-cost hub could benefit from relocation of activities closer to Europe.

Short-term

+ **FDI shock**
  - Inward investment slump during a global financial crisis
  - Resulting temporary decrease in competition

– **Demand shock**
  - Increased competition in light of general lower demand
  - Variation of impact across industries and sectors
  - E-commerce distribution channels as vital competitive advantage gain ground

– **“Buy local” initiatives**
  - Encouragement of consumers to buy local products and services in support of national economies
  - Resulting lower demand for foreign brands

Medium to long-term

– **Increased FDI and supply chain relocation**
  - European MNCs’ shifting their supply chain away from Asia to the geographically closer and still relatively cost-efficient CEE region to increase supply chain resilience
  - Increased integration in global supply chains and resulting higher competition for skilled labor and other production factors
  - Welcoming of Chinese investments to reboot CEE eco-nomies and mitigate fear of resurging Russian influence

– **Regionalization trend**
  - Return of key industries (e.g. pharmaceuticals, medical equipment) to the region to ensure the regions’ autarky

Overall, we expect the Covid-19 pandemic to result in increased competition for MNCs in the EU-CEE11 region. Whilst this trend could already be visible in the short-term, longer-term effects, such as the increased attractiveness of the region for other MNCs, have the potential to significantly change the region’s competitive landscape.

References: Accenture (2020), Brundsen & Peel (2020), Emerging Europe (2020), Erste Group Research (2020), Grady (2020), Zhou (2020)

Crisis gives rise to nationalistic ideas and immutability of power – foreign multinationals have to prepare for more demanding, less friendly governments

The crisis plays in favor of autocratic regimes. They are using the insecurity of the people to grab more power and strengthen their position.

Short-term

- **Local protectionism and nationalism**
  - The present governments get an opportunity to raise their power using populist slogans and support from the masses.
  - Right-wing parties are gaining popularity. It could drastically change the balance on the upcoming elections, e.g. Poland
  - Local protectionism will go against foreign multinationals. MNCs must expect to be first addressers for funding the empty state coffers.
- **Returning labor force**
  - Labor force returning from West and requesting for unemployment benefits can be a serious burden for the budget of governments. At the same time, they might put pressure on the political system to reform itself.

Medium to long-term

- **Stronger governments**
  - The quarantine prevents oppositions from protesting and ruling parties, as Fidesz in Hungary are using that inability of the opposition to get more power
  - MNCs will need to deal further with existing governments, which might apply a more unprincipled approach
- **Dependency on EU Funds**
  - EU holds € 37 billion for member states and additional €140 million for Eastern neighbors for the most immediate needs. Therefore, CEE countries still need to tightly cooperate with Brussel and seek for support from the next EU budget (2021-2027)

Foreign investors should closely monitor political risks in CEE countries, which are directly related to corruption rate and an unfriendly environment for MNCs, and prepare in their political strategies accordingly. Increasing conflicts with local governments are to be expected what will lead to an unfavorable investment climate and a reduction of FDI.

References: Euronews (2020), PwC (2020), The New Federalist (2020), The Washington Post (2020)

Institutional quality will probably decrease even more

The institutional quality in EU-CEE11 countries was already **lagging behind Western Europe** before the pandemic – it will probably not significantly improve after the crisis. A stronger power concentration will make it easier for corrupt governments to divert funds to close allies and supporters.

Short-term

+ **Digital public services will increase transparency**
  - CEE upgraded a larger number of public services to digital platforms during the pandemics. This process could lead to higher transparency of public decision making.

– **Unethical tendering schemes for public procurement**
  - Scandals involved massive corruption and forgery schemes
  - Contracts were given to questionable companies in Slovakia, forging of new contracts for medical equipment sourcing's with Chinese companies in Czechia

Medium to long-term

– **Looser EU guidelines for Member States**
  - Lack of domestic mechanisms that guarantee the transparent use of EU funds invites wrongful fund allocation

– **Public sourcing processes could be further exploited**
  - Future acquisition of adequate, needed supplies (e.g. in the area of healthcare) may be affected by the previous sourcing scandals and further embolden corrupt practices

– **Deficient government leadership styles**
  - The increased power for existing regimes could weaken avenues for democratic oversight and transparency

Overall, the chances are low that institutional quality will improve after the crisis – it might rather decrease due to power concentration at the government level. As institutional quality is one of the main decision criteria for FDI and is in many CEE countries unsatisfactory, the volume of foreign investments might decrease after the crisis.

References: China-CEE (2020), Coface (2018), Freedom House (2020b)

CEE countries can only capture the full potential of the digital transformation by mutual collaboration between governments and multinationals

Digitization can be the next driver of sustained growth for the uniquely positioned region, with €200 billions of additional GDP by 2025 at stake. These countries still heavily depend on FDI for achieving the status of an innovation-driven economy. So national governments have to be careful not to scare off investors and create investment friendly conditions.

Short term

- + Each CEE country has digital strengths in different areas. Sharing best practices can accelerate digitization in the region.
- + E-commerce got a push during the crisis and will increase its share in retailing in the future
- + Distant working schemes came to stay. It might activate people who were difficult to get integrated into the labor market.

Medium to long-term

- + Initiatives such as Industry 4.0 will benefit from a better digital infrastructure. It is also a precondition to get to a higher level of automation what is needed to compensate for the upcoming labor shortage.
- + Same is true of digital business services (shared service centers, BPO). Nearshoring and outsourcing will get a boost as they help reducing costs and acceptance of digital services will rise.
- – "Brain drain" and the lack of IT skills in the workforce will slow down a fast digitalization. A huge educational effort and reorientation is needed to tap the full potential of digitalization.

An improved digital infrastructure offers foreign multinationals more options in the upgrading of local operations. Strength areas such as the export of business services will benefit from an acceleration of digitization in CEE.

References: McKinsey (2018), Muzikárová (2020)

Global developments related to regionalization and protectionism bode ill for incumbent investors in CEE

Covid-19 outbreak might just create some **new opportunities** for CEE countries, such as the influx of foreign MNC in need of **new production locations for their value chain**. Nevertheless, **slowdown in global trade** and **changes in business climate** in CEE countries could unequivocally outweigh any potential benefits that might be gained during the virus outbreak, sending a clear signal to the investors.

Short-term

+ Proposal for the next MFF 2021-27 calls for **a reduction in CAP and cohesion spending**. This threat is currently mitigated by the € **750 billion Covid19 recovery plan,** with Poland and Slovakia being the **top beneficiaries**.
− Considering the **dependence of CEE on Germany** (as direct trade partner and as hub for CEE exports to non-European destinations) and disruption of global value chain amidst Covid-19, export-intensive CEE economies such as Hungary, Romania and Slovakia are **severely negatively impacted**.
− Due to potential new US-EU trade barriers, **a severely negative impact** on the export-intensive CEE economies is imminent.

Medium to long-term

− A reduced EU budget translates into **a negative effect. Changes in funding priorities** could have a negative impact and endanger the convergence process.
− The Visegrad Four and Romania in manufacturing, and the Baltics in services represent **good value locations** for (German) firms. This reconfiguration of supply chains results in **more competition** for incumbent companies due to new investors.
− Due to **further protectionist policies**, the USA could demand more local manufacturing replacing the imports from CEE (e.g., cars, electronics). If investors follow relocate to the USA to avoid higher tariffs, CEE will **inevitably lose in the long-term**.

Under the given circumstances, **regionalization** of value chains and increased **protectionism** will potentially force European investors to move their production or value activities to the US, thereby negatively affecting CEE countries. This reconfiguration of the global supply chain could result in more **competition from abroad** in CEE, too. That, coupled with fewer transfers from EU funds directed towards CEE, is highly likely to dampen the investment attractiveness for the incumbent Western multinationals in CEE.

References: Emerging Europe (2020)

Western multinationals in CEE should prepare for a more demanding state and a return of the labor shortage in the mid- to long-term

Western multinationals have built a strong presence in CEE over the last three decades. While the firms have enjoyed a little boom from 2015-19 in CEE, there exist some structural challenges that the **management** has to monitor to be prepared for upcoming changes.

We identified **six structural challenges** that should be on the **radar of Western multinationals operating in EU-CEE11**. Five out of them paint a rather negative scenario for the Western incumbents. Unfortunately, the Covid-19 pandemic is not really changing the direction of these trends. Only the labor shortage is stopped for now and digitalization of CEE economies will happen faster and push their transition to knowledge economies.

The dramatic **decline in workforce** in the mid- to long-term might be partly alleviated by automation, reverse brain drain and immigration but the lack of skilled employees could hinder the expansion of existing operations. **Nationalist-populist governments** and weak institutions pose many threats for foreign firms. One cannot expect that prevalent anti-democratic and protectionist developments as well as corrupt practices will disappear in post-pandemic times.

More management attention to national and regional developments is necessary to be well prepared for post-Covid-19 times

However, CEE governments will need the **cooperation of global players** to promote the development of their economies. They will push incumbent firms to **upgrade their operations** and include more R&D activities.

Furthermore, they will try to lure **new investors** to innovative sectors. The economies might even benefit from an inflow of FDI from Asian and North American multinationals which respond to the **regionalization** of supply chains by investing in Europe. This would mitigate the **exposure to the German economy** and diversify industry structure. The relationship to the EU will remain ambivalent.

Overall, **Western multinationals** should not expect an improvement of the **business and investment climate** in the post-pandemic era. They will face a stronger and more demanding state, intensified competition from within the region and overseas and a continuing labor and skills shortage in the mid- to long-term.

Moreover, Western investors will have to pay more attention to the affairs in individual countries and to upgrade their competencies in the area of **political strategies** and business diplomacy.

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CONTACT

Ass.Prof. Dr. Arnold Schuh
Director – Competence Center for Emerging Markets & CEE
WU Vienna
Welthandelsplatz 1, 1020 Vienna
Phone: +43 (0)1 31336-4608
E-Mail: arnold.schuh@wu.ac.at

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