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Gone west: Why eastern Europe is labouring under an abundance of jobs

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Jan Liman does not know how to safeguard the future of Meblat, his Warsaw-based kitchen furniture company. He has good sources of timber and plenty of orders. But he is short of skilled workers.

“Two [out of 12] workers have emigrated to Ireland. A third man has resigned saying he was also going to Ireland. Trying to find replacements has been fruitless,” he says.

The Polish entrepreneur’s complaints are echoed across the European Union’s new member states in central and eastern Europe. The squeeze is worst in the construction industry but is also gripping sectors as different as baking and banking. Engineers, technicians and factory hands are all in short supply.

Fuelled by strong economic growth and soaring foreign investment, employment is increasing in availability just as emigration has sucked around 5m workers from eastern to western Europe. According to Eurostat, the EU’s statistics agency, labour costs are growing at their fastest rate since the end of Communism – with a 30 per cent increase in nominal costs in Latvia in the year to last September and rises of more than 20 per cent in Romania, Estonia and Lithuania. In Poland, the largest new member, the rise was just under 12 per cent.

In real terms, average gross wages in Poland rose more than 7 per cent in the first nine months of 2007 and in Romania by nearly 16 per cent, according to the Vienna-based Wiiw research institute.

While unemployment levels in western Europe have stayed at around 8 per cent since 2002, in the east they have slid from 14 per cent to under 9 per cent. In the region’s booming capital cities, almost everybody who wants work has a job. Leszek Wronski, head of the central Europe division of KPMG, the accountant and management consultant, says: “We have a job market controlled by employees.”

For many east European workers, this control is very welcome. For 15 years they watched as company owners won much of the benefit of the post-Communist transition. Now workers are securing a bigger share of the rewards. As Donald Tusk, Poland’s prime minister, told the Financial Times recently: “The lack of labour in Poland is a problem in some industries ... But it is also important for people to enjoy the fruits of economic growth.”

However, for governments and companies alike, rising labour costs and growing skills shortages raise big questions about the region's future competitiveness. Everything from decisions on investment location to education, migration and population policies is coming under scrutiny.

There is no immediate need for panic. Even after the recent pay surges, differences between west and east Europe remain huge. In Germany, hourly labour costs are about €28 ($41.40, £21.15), compared with some €8 in the Czech Republic, €7.50 in Poland and €4 in Romania. Rafal Krasnodebski, a partner at the Warsaw office of PwC, the accountancy and consultancy group, says: "Poland and Slovakia were 70-80 per cent cheaper than western Europe in 2004. Now it's 60-70 per cent. So it's still cheaper [there] and likely to be cheaper for a long time to come."

The region has since 2002 seen a particularly sharp cyclical upswing in gross domestic product growth, averaging more than 5 per cent annually. Yet while east European economies slowly converge with those of western Europe, including in labour costs, the current pay surge contains significant one-off elements. An easing of restrictions on working in western Europe, which accompanied EU enlargement, has allowed millions to emigrate, particularly from Poland and Romania, the two most populous countries. Pay has risen fastest for those in greatest demand in the west. Building workers' wages last year rose 20 per cent in Poland, 25 per cent in Romania and 35 per cent in Latvia.

Now, with a credit squeeze hampering the US economy and clouding the western European outlook, economists are examining prospects for the EU's new members. While most see continued solid growth, they expect a slowdown from 6.5 per cent last year to perhaps 5 per cent in 2008. Some governments and central banks in the region are in any case slowing growth by trying to reduce high inflation and current account deficits. Zbigniew Kominek, a senior economist at the European Bank for Reconstruction and Development, the multilateral bank for the ex-Communist countries, says: "The cyclical increase in economic growth will not last indefinitely."

However, even if labour markets ease a little, there will be no return to the super-abundance of workers of five years ago. The region's populations are ageing even faster than in western Europe and, with the added effects of migration, the number of working-age people is falling in the Baltic states and central Europe. Eurostat predicts that the population of the new member states will decline from 103.6m in 2004 to under 100.6m in 2015, with particularly sharp drops in working-age people.

So companies and governments must prepare for a long period of tight labour markets. For policymakers, the first task is to raise employment rates. The region is burdened with low rates of participation in the labour market, especially among older people. In Poland, the employment rate at the end of 2006 was just 54.5 per cent, compared with 67.5 per cent in Germany and 77.4 per cent in Denmark, the EU's highest rate. Among people aged 55-64, the Polish employment rate was just 28.1 per cent, compared with 48.4 per cent in Germany.

The east European numbers are depressed by the use of early retirement and disability awards during the post-Communist restructuring. But political leaders are cautious about limiting access to welfare or initiating other policies that might provoke a backlash. After years of effort, the region is suffering reform fatigue.

Next, policymakers and employers will need to ensure wage labour productivity keeps pace with labour cost increases. According to a report this week by the Conference Board, a US business research organisation, labour productivity in the east is much lower than in the west. In Poland, for example, it was just 40 per cent of German levels. But the difference in unit labour costs is much greater, so employers continue to relocate labour-intensive operations from west to east – as Finland's **Nokia** announced this week it would do, closing a German mobile phone plant with the loss of 2,300 jobs and expanding a Romanian factory that will employ 3,500.

However, as Capital Economics, a UK-based research group, warns in a report this week, in Poland and the Czech Republic (though not in Slovakia) recent wage increases have exceeded productivity gains. In Romania, Christian Popa, deputy central bank governor, says further labour market reforms are needed to improve flexibility and so raise productivity. "I believe this is the solution and it's no quick fix."

The Lisbon Council, a Brussels-based think-tank, says in a report that governments and employers must redouble efforts to raise productivity through better education and training. "The countries of central and eastern Europe lag western Europe considerably in human capital acquisition and deployment." The report argues that while the region's schools are broadly as effective as western Europe's, there are big gaps in lifetime adult education, including on-the-job training. Older workers, trained in obsolete ways under Communism, face the greatest difficulties.

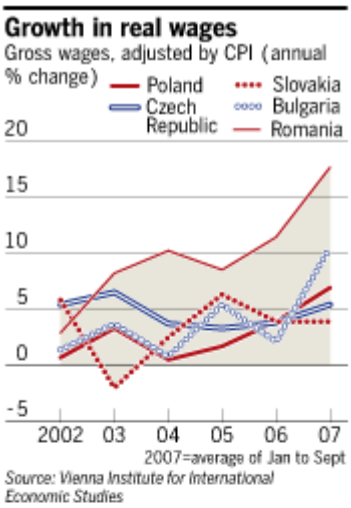
Companies are also responding to rising wages by demanding more from their workers. In business services, workers are being transferred to higher added-value operations involving direct contact with clients, while simpler functions are moved to China and India. Marketing and financial services groups, driven to pay €100,000 a year or more for experienced executives, are giving them tougher targets.

Even for high-paying international banks, personnel management is a headache. Stephen van Groningen, head of the Romanian subsidiary of Raiffeisen International, the Austrian bank, says: "The situation is unsustainable. People are becoming extremely opportunistic in job hunting. People come to work for the bank and leave after three months. Three months later they want to come back – and in certain cases I have to say yes."

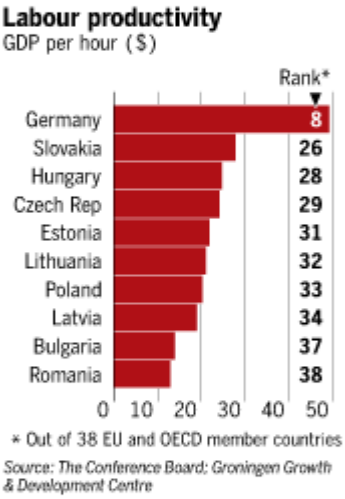
Lower down the wage ladder, life is tougher for employers, particularly at smaller companies. Agnieszka Jagiela, recruitment manager at 5 a Sec, a Polish dry cleaning chain with 80 outlets, says: "High staff turnover is a constant problem even though we pay close to the national average wage and offer four kinds of bonus." Construction is booming at a time when workers are in demand across Europe. Diwaker Singh, managing director of Copper Beech, a Romanian property developer, says: "There is a desperate shortage of labour because there are many projects happening and so many emigrants."

Many employers are responding by improving perks, such as company cars, and trying to retain staff through loyalty bonuses, training schemes and career development. For multinationals this is familiar territory. But for inexperienced local employers it is often new. Marek Masalski, head of Grupa Konsultacyjna, an employment agency in eastern Poland, says: "Some employers are still not fully aware of the importance of non-pay factors in motivating and employing people."

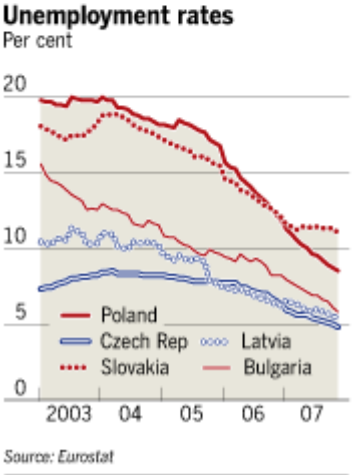
So far, rising labour costs are not affecting the region's overall attraction. The EBRD estimates that foreign direct investment into central and south-east Europe last year totalled $44bn (£22bn, €30bn), the fourth strong year in succession. Companies that see eastern Europe as a market as well as a cheap-labour base are glad of the increased spending power that higher pay brings. Also, a lot of current FDI is being generated by multinationals already well established in eastern Europe, notably carmakers, which are bringing their component suppliers into the region.



But among more mobile, cost-conscious investors, there is a clear shift away from hotspots including Prague, Warsaw, Budapest and Bratislava, where labour is short, in favour of locations offering more scope for recruitment. Favoured regions include Silesia in Poland and large parts of Romania, while pioneers are looking further east – beyond the EU, to Ukraine and Moldova.



Textile companies, particularly sensitive to labour costs, have led the way. But other groups are not far behind, such as Genpact, a US business services provider part-owned by **General Electric**, which started in eastern Europe in 2002 by opening a centre in Budapest. Now it is focusing on Romania, where it launched a Bucharest operation in 2005 and another in the northern city of Cluj last year. Patrick Cogny, chief executive of Genpact in Europe, says lower labour costs, including payroll and income taxes, have been decisive in investing in Romania; now Ukraine and Moldova are on his planning horizon.



Local companies are also heading to cheaper locations. Polish furniture makers have started outsourcing work to Ukrainian and Belarussian partners. Hermes Softlab, a Slovenian software developer, has created 200 jobs in Bosnia, Serbia and Montenegro – one-quarter of its total payroll.

But just as EU accession has made it easier for workers to move west, it has made life harder for would-be migrants from further east. Ukrainians, who enjoyed visa-free travel to Poland, now face bureaucratic hurdles. Moldovans have difficulty entering Romania. Employers want an easing of restrictions. They are also recruiting labour further afield by, for example, bringing in workers from Vietnam, China and North Korea on short-term contracts.

Whatever employers do, governments will sooner or later, as in western Europe, be obliged to consider the controversial question of migration if their region is to extend its rapid economic progress.