



Risk Advisory

Helping our clients evaluate,
manage and mitigate risk

In the last three years The Risk Advisory Group has witnessed an increase, both in volume and scale, in foreign direct investment (FDI) in central and eastern European countries. With their highly-educated and skilled workforces and low labour costs, the new accession states in these regions have the potential for rapid economic growth.

In this edition of Risk Advisory we focus on this opportunity for Western businesses. Articles by two experts from our Emerging Markets team, who experienced the transition first-hand, provide insights into developments in Slovakia and Bulgaria.



“...effective due diligence and appropriate systems and controls are required in order for Western investors to avoid the pitfalls...”

Following these insights, we are pleased to include two specially-commissioned articles by Steven Fries, acting chief economist at the European Bank for Reconstruction and Development, and Brendan Donnelly, the director of the Federal Trust for Education and Research, a London-based think tank. While Fries looks at other prospects for development in the post-communist region, Donnelly considers the successes and problems of an ever-widening European Union and the issues associated with further rounds of enlargement.

Finally, Charles Skinner, of The Risk Advisory Group, provides perspectives on his recent assignment in Tirana to illustrate the social, economic and political contrasts which characterise Albania today.

It is our view that the issues which arise from their thoughts, on organised crime, corruption and bureaucracy, are manageable should appropriate reforms continue. The increase in FDI that we have seen from our clients supports this view. However, effective due diligence and appropriate systems and controls are required in order for Western investors to avoid commercial failure, as well as the pitfalls of regulatory and reputational risk.

We hope you enjoy the articles.

Bill Waite
Group Chief Executive

IN THIS ISSUE:

- 2 Is joining the EU the only way forward?
- 3 Slovakia: a central European miracle
- 4 Bulgarian business anticipates EU membership
- 5 An ever-wider European Union?
- 6 Spotlight: Tirana



Is joining the EU the only way forward?

Steven Fries, European Bank for Reconstruction and Development

The European Commission set out in October the final hurdles that must be cleared by Bulgaria and Romania in order to join the European Union in January 2007. These remaining issues are among the many reforms that the countries have had to adopt in the accession process that began over eight years ago. Together with the eight new EU member states from eastern Europe that joined in May 2004, no group of countries has covered such vast reform ground in such a short period of time, and they are likely to be joined in time by the other countries in south-east Europe that are not yet candidate EU member countries.

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So why has the prospect of EU accession had such a powerful effect? There are several reasons and it is important to understand them in order to see the other ways forward in the post-communist transition region. This is particularly important for CIS countries, most of which are unlikely to become candidates for EU membership.

One key reason why EU accession had such a galvanising effect on reforms is geopolitical in nature. In the post-communist states of eastern Europe, there was a widely shared aspiration to rejoin the West and its market-based democracies and to escape Soviet and Russian hegemony. EU and NATO membership were their two options to achieve this goal. The price of admission to the EU was comprehensive market reforms and strengthened democratic institutions, a price that was willingly paid even though it involved enormous change and painful job losses in uncompetitive industries. The strategic aim of rejoining the West made it easier for politicians to stay the reform course when the pain set in and before the benefits began to accrue.

The changes imposed by the EU accession process came with many new opportunities. Some arose from trade liberalisation with the candidate EU member countries. Further opportunities arose from reforms required for EU membership which removed entry barriers to local markets and improved the business environment so that local entrepreneurs stood a much better chance of success. Yet more arose from the strong inflows of foreign direct investment into the candidate countries. In time, these forces were powerful drivers of change, supporting a burgeoning middle class that could freely express its political preferences through the ballot box.

In addition, the state institutions in the candidate countries had to be overhauled. This root and branch change was supported not only through technical assistance from the European Commission and other donors but also through widespread engagement with existing EU members and the United States. Chang-

ing the way a state functions requires much more than a generous loan to the government and a handful of technical advisors. It requires broad and deep exposure to alternative ways of governing together with leadership from the top.

From this assessment it is clear that EU accession is not the only way forward in the post-communist region, since many – but not all – of the factors for success can be created without the accession prospect. This includes elimination of trade barriers faced by CIS exporters, reduction of barriers to entry into local markets, increased openness to foreign direct investment, and comprehensive engagement with the international community in reforming state institutions. However, the CIS countries have not and most probably will not enjoy the political support for market and democratic reforms that the prospect of EU accession can bring. Its poor cousin, the European Neighbourhood Policy of the EU, is a far weaker beacon for reform than the accession process.

In the CIS countries, moreover, social consensus on market reforms and democracy is much weaker than elsewhere in the transition region, with large parts of the population and business community still tied to Russia ethnically, linguistically or commercially. As importantly, many countries do not benefit from real political competition, which can limit the influence of vested interests, reduce the scale of corruption and support market reforms.

Provided that the political systems in the CIS become or remain sufficiently open and contestable, many CIS countries could also pursue the same reform path that has been followed by the new EU member countries and the current and likely candidate EU member countries. The key will be whether the reforms implemented so far in the CIS will in time foster a sufficiently large and powerful middle class that will have a strong interest in sustaining and deepening market and democratic reforms. The CIS countries have not and are unlikely to travel along this path as quickly as have other transition countries, but they may be able to reach the same destination as long as they are not trapped by often powerful vested interests that can thwart change.

Steven Fries is acting chief economist at the European Bank for Reconstruction and Development.



Slovakia: a central European miracle

Lygia Kristova, *The Risk Advisory Group*

In recent years Slovakia has become a regular topic in many international publications. The significance of the country has been discovered not just in terms of its convenient location, natural and historical beauty, but also for its sudden economic significance.

The Austrian *Der Standard* called it the Detroit of Europe, and in financial circles it has been referred to as the tiger of Central Europe. A 2004 World Bank report noted that it had done more than any other country to improve its business environment.

So, why did this until recently unnoticed country of merely 5.4 million inhabitants become worthy of international headlines? How could a country that was so often confused with Slovenia, or labelled as part of the Czech Republic, suddenly host a Bush-Putin meeting of world importance? Slovakia was a country whose economic and political progress was so far behind its neighbours a few years ago that it was not even considered as a possible member of the European Union.

After peacefully separating from the Czechs in January 1993, a dark future was predicted for Slovakia. Its first years of independence were marked by the rule of Vladimir Meciar, a prime minister who pursued nationalist and populist policies. Hostile relations with the EU and NATO were combined with the rejection of economic reforms. This turned the country into a repressive, corrupt and mafia-ridden establishment with a collapsing economy.

In October 1998, an unlikely union of political parties including liberals, centralists, left-wingers and ethnic Hungarians forced out the Meciar government, and a coalition was formed under the new prime minister, Mikulas Dzurinda. Since then, Slovakia has become a central European miracle. The newly adopted policies of the Dzurinda government ensured that this once forgotten country was considered for membership of NATO and the EU, which Slovakia joined in 2004.

Most Slovaks welcomed the prospect of EU membership. They saw it as the only way to progress and as a passport to international acceptance. Whilst the politicians and the business sector praised the financial and economic benefits, the younger generation saw an opportunity in the free movement of workers.

However, the illusions of becoming an equal member faded towards the end of 2003. Media reports appeared suggesting that a flow of cheap eastern European workers was about to flood the labour markets of the founding member states. After stories conjuring images of welfare-hungry gypsies spread, a panic ensued. By May 2004 almost all member states (except the UK and Ireland) had applied restrictions to the free move-

ment of labour from accession countries, in contradiction of basic European principles.

Many Slovaks were deeply disappointed by the reaction of western Europe and felt that their country was being treated as a second class member. People started to wonder if the promised dream of a united and equal Europe would ever happen. But despite all the worries, there is no doubt that joining the EU was beneficial to Slovakia. Because of membership, investment has increased, badly needed legal and economic measures have been taken and corruption is now being tackled on a larger scale. In order to create a better business environment, in January 2004 Slovakia introduced a 19% flat tax rate for both individuals and businesses.

One of the highest priorities of the Dzurinda government was to attract large foreign investment which would then create new employment opportunities for the local population. The combination of government incentives and the availability of relatively cheap, skilled workers has resulted in companies such as Volkswagen, Kia Motors, PSA Peugeot and Getrag Ford investing in manufacturing plants.

Not all things are ideal, however. According to the latest statistics, many Slovaks continue to live in poverty. These people are mainly of Roma origin and are based in the east of the country where unemployment is highest. Despite the obvious efforts of the government, the situation is critical. Similarly the efforts in fighting corruption are believed by many to be insufficient. Although there is evidence of improvement, the results are still below the European average, according to Transparency International. Political stability is also questionable. Due to the variability of ideologies present in the four-party coalition and the constant attacks of the opposition parties, the long term survival prospects of the government are in doubt. Corruption scandals involving high-ranking politicians seem to be part of everyday life and people are starting to lose faith in these politicians, if not politics. Slovakia, a little miracle to the outside world, is less miraculous to its own nationals.

Despite all these challenges, an insignificant country a few years ago is now beating in the heart of Europe. This is indeed a miracle, which may not have been possible without the economic incentive of EU membership.

“Most Slovaks welcomed membership to the EU. They saw it as the only new way to progress...”

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Bulgarian business anticipates EU membership

Liliya Gelemerova, *The Risk Advisory Group*

Despite continuous problems since applying for European Union membership in 1995, Bulgaria has managed the transition to a free market economy. With only a year left until Bulgaria joins the EU, it is clear that the process of harmonisation to EU standards has created a more stable and predictable business environment.

Small and medium enterprises now have better access to loan capital, information and technology. Bulgaria's banking services and infrastructure have improved. Arguably, the tax burden is lower and the legal framework is clearer.

The conditions for foreign investment have also improved. The currency board has ensured microeconomic stability and low inflation. The geopolitical location of Bulgaria, low operational costs and tax rates, highly-skilled yet cheap labour as well as a number of treaties for avoidance of double taxation and agreements on mutual protection are some of the factors which make Bulgaria attractive to foreign investors.

Among the success stories outlined by Invest-Bulgaria Agency, IBA, are the acquisition of the copper smelter and refinery in Pirdop by the Belgian Umicore SA; the privatisation of Avangard by the global leader in power and automation technologies Asea Brown Boveri; and the investments of Lindner Group in Business Park Sofia. IBA quotes figures from UNCTAD



which list Bulgaria among the top destinations of foreign direct investment. With \$2.5 billion of FDI, Bulgaria ranks 1st in the south-east Europe division and 12th in the global FDI index of UNCTAD for 2004. In November, Bulgaria was ranked 15th out of the 40 top outsourcing destinations worldwide in its first appearance in the A.T.Kearney's annual research. Slovakia and Romania, two other new entrants to the list, were ranked 16th and 24th respectively. The three major criteria considered by A.T.Kearney are cost, people skills plus availability and business environment.

IBA figures show that Austria is the leading investor in Bulgaria, with a total of \$1.858 billion from 1992 to June 2005, followed by Greece, Germany, the Netherlands, Italy, Switzerland, Cyprus and the USA. The United Kingdom is 12th with \$387.8 million, followed by Russia with \$228.9 million. The UK, however, has gradually gained momentum and in 2005, it was third in terms of investment, with only Austria and Switzerland ahead.

UK businesses have shown a particular interest in the Bulgarian property market and tourism. Along with the traditional seaside resorts, winter ski resorts in Bulgaria are now a popular destination for British tourists. Sofia's prospects of hosting the 2014 Winter Olympics has encouraged investment in ski resorts such

as Bansko. There is a growing interest on the part of foreign investment funds to buy shopping malls at various stage of construction, as *Capital Weekly's* analysts report.

Sustained economic growth, financial stability and minimal political risk are among the major achievements of the Bulgarian authorities over the last few years. Bulgaria has been under significant pressure from EU institutions and the IMF. Yet the EU Commission claims there is still much work to be done. The monitoring report published in the autumn of 2005 outlined a number of areas that need to be particularly addressed over the next year. The reforms in the judicial and administrative systems must be accelerated. Bureaucracy is still considered a major restraint on business in Bulgaria.

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Despite relatively low operational costs in Bulgaria, foreign investors often find it frustrating that a substantial portion of the cost goes to coping with the huge amount of paperwork. High transitional costs of complying with new regulations have been even more difficult for small and medium enterprises.

Additionally, the commission's report has flagged corruption and economic crime as two major problems that need to be tackled quickly and efficiently. Although corruption has been a concern for many governments both in developed and developing countries, it is accentuated in Bulgaria by a high level of organised economic crime. Public murders such as the assassination of one of the most influential businessmen in Bulgaria, the head of the financial group DZI, Emil Kyulev, which coincidentally took place at the time when the EU commission released its report, are a striking example of the scale of economic crime in Bulgaria. However, these should probably be viewed as isolated incidents which should by no means scare off investors. Rather, problematic and much-disputed investment projects, such as the Trakiya Highway and the Varna and Bourgas concession deals, more accurately expose some of the uncertainty and potential risks that still exist for Bulgarian businesses.

But for those who manage to balance, instead of avoid, the risk, Bulgaria may become the site of the next gold rush. Indeed, this has just happened for Cambridge Mineral Resources plc, which recently found a gold deposit in the central-Bulgaria Polski Gradets permit.

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An ever-wider European Union?

Brendan Donnelly, The Federal Trust for Education and Research

Since its founding in 1957 with six member states, the borders of the European Union have constantly widened, as over the past fifty years another nineteen countries have joined the Union. For most of these new countries, joining the Union has marked an important and positive new stage in their modern national history. Spain, Portugal and Greece saw their membership of the Union as consolidating their newly-established democracies, while Ireland's economic transformation over the past thirty years has owed much to its access to the European market and the Union's regional and national development funding. Few would deny that the prospect of joining the European Union has acted in the past fifteen years as a powerful stabilising factor for the economically and politically uncertain democracies in Eastern and Central Europe which emerged from the wreckage of the Warsaw Pact.

This last success of the European Union in helping its neighbours to modernise and democratise their initially fragile societies has led many of the Union's leaders to believe that this process is indefinitely repeatable. Bulgaria and Romania are due to join the Union in the near future, and there are definite prospects of membership in the medium term for Western Balkan countries such as Croatia and possibly even Serbia, and formal negotiations began with Turkey in October for that country to join the Union in perhaps ten years time. Advocates of this ambitious widening of the Union reasonably argue that, in all the above-mentioned countries, negotiations for membership of the Union will serve to bind the countries concerned, as nothing else could, into the democratic and free-trading family of European nations.



But there is another side to these undoubtedly persuasive arguments that forms a central part of the European debate as to where the limits of the European Union do and should lie. There is a feeling that the Union is expanding too far, too fast and that the sense of a common endeavour is being lost as new countries enter the Union with radically different aspirations and expectations that may upset the Union's delicate decision-making structures and largely shared political culture. This unease was a decisive factor in the rejection of the European Constitutional Treaty in France earlier this year. Most French voters believe that the enlargement of the Union to include the former Soviet bloc countries in May last year was premature. They have considerable doubts about whether it would ever be appropriate to allow Turkey, most of which has always been regarded geographically as lying outside the European continent, ever to join

the European Union.

Of course there is sometimes an element of selfishness and prejudice in such arguments. But the question about where the geographic limits of the European Union should lie is hardly a trivial one, and it is one to which Europe's leaders find it difficult to give an answer. Geography and culture certainly influence national perceptions of what it means to be European and where Europe ends. The EU's current discussion about enlargement is an evolving one, in which there are more uncertainties than fixed points. There are voices in the Union arguing for intermediate arrangements with the Union's neighbours, short of full membership. But what seems to some a reasonable compromise along these lines can seem to others the worst of both worlds, a patronising bribe from the European Union to accept second-class status.

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The question of the European Union's boundaries is inseparable from that of the Union's nature and ultimate destination. Those who see the European Union as primarily an efficient and effective instrument for social, economic and political progress will naturally be drawn to the widest possible European Union, in which this progress is as widely distributed as possible. Those who conceive of the Union as primarily a political expression of a shared European political identity, an identity to be deepened and manifested through the European Union, may be more concerned by what they will see as the "dilution" of the Union through its excessive widening.

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Brendan Donnelly is the director of the Federal Trust for Education and Research, a London-based think tank. He is a former Member of the European Parliament, where he specialised in European institutional questions.



Spotlight: Tirana

Charles Skinner, Janusian Security Risk Management

Whatever your perceptions of Albania may be, stark contrasts exist which are best described by the academic, Clarissa de Waal, in her book 'Albania Today'. She highlights Albania's third-world economy and infrastructure in contrast to its flourishing first-world education, literature and arts scene.

The road from the airport to Tirana is badly potholed in many places and the traffic gets increasingly chaotic as you approach the city centre. Tirana seems to be in a state of gridlock during daylight hours.

Along the way, you will experience some eye-opening snapshots of contemporary urban life in Albania: a person using a high pressure hose to wash the gravel area by his shop while standing in the rain, roadside stalls selling second-hand car wheel hubs and the astonishing makeover of the once drab Soviet-style apartment blocks achieved by painting abstract colour designs on their walls. Huge glass-fronted facades of new commercial developments stand in sharp contrast to the rest of Tirana's buildings, which are usually incomplete. Albania remains a cash economy, and it appears that building work ceases when the cash runs out.

Edi Rama, a former artist, is Tirana's colourful mayor and the chairman of the Socialist Party. Not surprisingly, he is responsible for the psychedelic makeover of Tirana, but popular feeling is that the national government is not proactive enough and merely puts out, rather than prevents, fires. The state of the country's electricity supply is the latest crisis: the northern Fierza hydroelectric power station does not have sufficient water to meet national demand. The situation is exacerbated because the Albanian Power Corporation (KESH) does not have the legal authority to purchase electricity from abroad in crises. The rationing of electricity



has led to water flow interruptions in some stations in the southern city of Gjirokastra. KESH promises that the situation will get better, but the cold

weather has increased domestic demand by 30%. In addition to these problems, KESH is now grappling with the logistical problem posed by the lack of available transit power lines to import energy from neighbouring countries.

"Albania's security situation is brighter with the promise of NATO membership as early as next year."

Albania is currently ranked among the poorest countries in Europe with more than 40% unemployment. From the outside, Albania is largely perceived as a centre for the trafficking of drugs and people, corruption and organised criminality. But Tirana is a city in rapid transformation with bold plans for the future, and Albania's notoriety only adds to the urgency surrounding the country's headlong rush towards EU membership acceptance. The next hurdle in the EU accession process is the implementation of the Stabilisation and Association Agreement, but the enlargement commissioner has already warned of the need to address organised crime and trafficking across borders, improve environmental standards and develop cross-party consensus.

Part of the necessary transformation programme is judicial reform, which could help stem corruption. During the 45 years of communist rule, judges took their orders from the ruling party; since the fall of communism, the

National Democratic Institute has spent more than \$40 million promoting democratic reform by training Albanian lawyers and judges, with the hope of fostering an independent judiciary. Albania's security situation is brighter with the promise of NATO membership as early as next year.

Leaving Albania provides one final contrast: as you enter the airport departure lounge you cannot help but notice a small, but very well stocked, bookstore with an extensive array of novels and non-fiction books covering a broad range of subjects such as history, the arts and many other general interest subjects, but all in English. This would be a rare find in any airport of comparable size in the UK, and perhaps demonstrates most clearly Albania's increasingly outward-looking face.

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