

The expanded EU

The dream finally came true with central and east European countries joining the European Union last year. After over forty years of Soviet 'velvet occupation' Poland, the Czech Republic, Slovakia, Hungary, Lithuania, Latvia and Estonia have joined the EU. Although celebrated in all new member states with fireworks and much rejoicing, 1st May 2004 did not bring any immediate or visible changes in the everyday life of the average citizen.

However, after five months in the extended EU some changes have occurred and everybody hopes further positive changes will follow. The new member states joined the EU with out-dated economies and living standards reaching only between 40-50% of the average across the rest of Europe. Some twenty to thirty years will be needed for living standards across the whole of the EU to become roughly the same.

How has this further expansion of the EU affected the leather and footwear sectors in the new states? Believe it or not, there were no immediate effects from integration and little influence on both sectors. The economic processes that began fourteen years earlier, when the countries rid themselves of the old communist system, created a far greater shock than joining the EU. Indeed, all new member-states were already suffering the same decreases as the rest of Europe in leather and shoe production and the same increases in imports of cheaper goods from China and the Far East.

Footwear and leather production in Poland, the Czech Republic, Slovakia and Hungary is much, much smaller in terms of quantity, but has greatly improved as far as quality is concerned. This only partly is due to the influence of high quality imported goods from the West. Domestic production of leather and leather goods has been wholly privatised and modernised such that both sectors are capable of competing with imported products.

If you ask tanners and shoe manufacturers about the

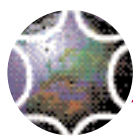
immediate effect of EU expansion on their businesses, almost all will say there were no big changes. The big changes occurred in the late 80s and early 90s when they purchased bankrupt state companies or launched their own tanneries or shoe factories. Economic conditions were changed dramatically at that time from an ineffective state controlled economy to a free market economy. During the subsequent fourteen years regulations have been modified to generally come into line with European laws, regulations and standards. Joining the EU on 1st of May did not require an immediate revolution.

Relief and savings

However, everyone will confirm one crucial change and that is the freedom of transport and trade within the EU. Long queues of lorries at the borders, numerous customs controls and bureaucratic obstacles in foreign trade suddenly became part of the past and just a bad memory. No customs duties, simplified paper work and documents and no need to pay VAT at the border have not only brought relief to shoe and leather manufacturers (both importers and exporters) but also a considerable saving. VAT in Poland for example, amounts to 22%.

Personal freedom to cross the earlier well-protected borders is also well worth mentioning. An East European businessman carrying shoe or leather samples in a car boot could experience immense troubles with customs at the border if a strict officer decided he had found some 'illegally smuggled goods'. This could apply even if they were only half pair samples of no commercial value. This sort of obstacle is once again all in the past.

Of course, the open EU market also means increased competition from other EU states. Polish tanners must now fight Italian and Spanish competitors not only in terms of quality and price but also in extended or deferred payment terms, which they are unable to provide. Czech shoe manufacturers have drastically decreased production due not only to huge imports from the ►



Far East but also from Spain and Portugal. The market for raw hides and skins in new EU member states is now well penetrated by Italian, Spanish and Portuguese buyers, resulting in increased prices for domestically produced raw materials.

The effects are already visible. The tanning industry is progressively shrinking with a smaller leather production in Poland, the Czech Republic and Slovakia. Only a few months ago two major Polish tanneries in Nysa and Bialystok went out of business. Shoe production in the Czech Republic and Poland is also in decline. This trend in nearly all of the new member states does not necessarily mean the demise of either sector. The tanneries and shoe factories are all in private hands, all making efforts to modernise production and improve marketing skills and effectiveness. The positive aspects they see are not only in free trade and closer co-operation with other EU countries but, more importantly, increased trade links with Russia, the CIS states, China and the USA.

From the consumers' point of view in all former communist states, the 'new world' looks promising. Although jobless figures are high (especially Poland at 19%) and personal incomes are not impressive, at least there are better prospects for future. Since 1st of May 2004 Poland, the Czech Republic, Slovakia and the remaining new EU member states are changing at a much faster rate. The adoption of the euro, scheduled for 2007 to 2009 depending on country, will be the next important step in building a more unified Europe.

A struggle to woo the West back from the East

With the big structural change from state ownership to privatisation made in most of the new accession countries over a decade ago, where do they sit now? Certainly the process of accelerating wealth has been visible in some Hungary, for example, is already recognised as having become too expensive for significant parts of the leather industry compared to what is happening in south-east Asia.

Frustration of this sort has been felt in most of the new members of the EU. They have a long leather tradition, in both manufacture and use, and could well have expected to obtain a large share of western Europe's peripatetic tanning and leather products industry and of the final consumption of leather shoes and goods.

Some shoemaking left Italy for Hungary but often production lasted less than eighteen months, before the weak dollar and associated high value of the euro led to an almost immediate transfer to Asian destinations such as Indonesia, China and Vietnam. Similarly, German and Dutch glove makers such as Roeckl Handschuhe and Modena-Laimbock began making major use of Eastern Europe, where glove making has a strong history. Both accept, however, that Asia has to start figuring more and more strongly. This is a big pointer as it is clear that for European makers and importers the ease of quality control, of faster shipping and of managing smaller orders directly to the customer is a big attraction over importing large volumes from China.

Other countries such as India have also entered this debate and groups of shoemakers from different European countries have been touring India to consider joint venture opportunities in a country that has a strong leather industry, good domestic raw material

supplies and labour costs in a banding much closer to the Chinese model than to the European.

Shifting production to former Eastern bloc countries can, nevertheless, help the newly enlarged European Union combat the threat to the fashion industry from China.

The head of the powerful Camera Nazionale della Moda in Milan, Mario Boselli, said recently in an interview on the sidelines of the ready-to-wear shows: "I think this is definitely the correct way to counter loss of competitiveness for two reasons. [Firstly] for production. Some products can no longer be manufactured economically in the EU, except maybe in Portugal. Manufacturing in eastern Europe gives the EU the chance to produce in more favourable conditions. The markets are also interesting in terms of growth."

Boselli himself heads a manufacturing group which has opened a factory in Slovakia. He stressed the need for factories to be geographically close to the heart of the business so as to maintain control. This is why he does not view fashion houses entering into joint enterprises in China favourably. "You are teaching them the job which could have a long-term negative effect. And then China is so far away that it is not possible to exercise control."

The value of the eastern and central European countries as a manufacturing base remains considerable and car companies such as Volkswagen are already seeing the big difference between the Czech Republic and Germany. Giving the Czech Republic the tools has allowed the production of sought-after Skodas and made the country a quality producer of both Volkswagen and parts of Porsche models, while the company struggles to manage escalating costs in Germany.

ECCO hurried into Slovakia but subsequent development has been limited and, unlike other ECCO destinations no tannery has been built. Recently, more has been spent in ECCO facilities in Thailand and Indonesia and a shoe factory and tannery project is underway in China. It would appear that while there is certainly a positive movement into the central European countries mostly from Italy but to a lesser degree from Germany, the attraction of low cost and the ease of doing business in Asia creates very strong competition.

Is Russia more interesting?

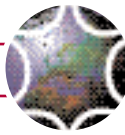
The 2004 view of the leather supply industry on the new European countries is rather a shrug of the shoulder, indicating that little has changed in the last twelve months. "Russia looks more interesting" is the answer to a question on the evolution of the leather industry in the eastern European area.

The trends of the last 15 years are apparent when looking at the figures for Poland in Table 1 and for the Czech shoe industry for the same period in Table 2.

Most obvious is that both tables demonstrate the catastrophic

Table 1: Leather and footwear production in Poland

	units	1990	1993	1995	1996	1997	1998	1999	2000
Vegetable-tanned leather	1000 tons	4.0	1.7	0.4	0.5	0.6	0.2	0.2	0.2
Chrome-tanned leather	Mill m ²	20.2	10.8	12.2	12.4	13.4	11.6	8.9	8.7
Total shoe production	Mill pairs	105.0	50.7	62.8	69.9	71.9	57.1	50.4	46.7
Including: -with leather uppers	Mill pairs	43.3	20.9	24.6	26.9	27.7	24.4	21.5	18.1



declines in production from 1990 to 1993 that took place in all the ex-Soviet controlled countries. In most instances this led to the production in all sectors in both countries being cut almost precisely in half.

This was followed by a period of stability and some indication of recovery. In the Poland of 1990 90% of the industry was state-owned while a decade later this was only 10%.

Yet as the markets opened to imports while the countries prepared for EU membership, the industry struggled to compete. Footwear imports, especially from China, began to expand and the industry again came under pressure. Footwear production fell and with it tanning output. In 1999, after a long campaign by the PCSLI (Polish Chamber for the Shoe and Leather Industry) some duties were imposed to control imports but these had limited effect. Imports from Taiwan and Vietnam grew instead and some less scrupulous Chinese producers appeared able to evade duty by various clandestine means.

Counterfeit footwear is also a big issue for all of the central European countries, including those like Romania which are not yet part of the EU. For example, earlier this year a pile of around 100,000 fake pairs of sports footwear were burnt in the Romanian town of Megidia in a demonstration against counterfeit products.

The shoes were imported from China and their sales value was estimated at about \$2.2 million. The organisers invited one of the lawyers from Puma to the event, who praised the efforts of the Romanian authorities to fight illegal imports of counterfeit shoes into the country.

Genuine Puma, Nike, adidas and Reebok footwear, which the counterfeits imitated, were offered to Romanian orphanages, together with branded garments as a “thank you” token for the country’s anti-counterfeit move. Earlier in the year the European Glove Association noted that Chinese gloves were arriving in Russia with false Made in Romania labels on them.

Under these pressures Poland and other central and eastern European countries remain engaged in a tough battle for prosperity and profit.

The view from the Czech Republic

The same story is repeated in the Czech Republic. Currently, the Czech shoe industry comprises about 60 companies with more than 20 employees each. However, shoes are made also in a number of micro businesses having substantially fewer employees (10-20). During 2003 about 6.5 million pairs were manufactured in the Czech Republic but over 44 million pairs were imported, with China again being the decisive contributor of the imports. In 2003 more than 31.8 million pairs were imported from China—which adds up to more than three pairs per inhabitant. Chinese shoes, though, are imported for low unit prices. In 2003 this was only about \$2 per pair. Exports were at the level of about 8.1 million pairs (including re-exports). The local shoe market has about 42.4 million pairs capacity at the present day, the average consumption being ►

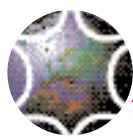


Table 2: Balance of Footwear Production, Exports, Imports and Consumption: Czech Republic 1990-2003

	1990	1991	1992	1993	1994	1995	1996
Shoe production (mill. pairs)	71	45	37	32	30	28	26
Export (mill. pairs)	43	32	26	20	21	17	17
Import (mill. pairs)	11	3	7	16	20	25	24
Per capita consumption (pairs)	5.09*	3.30*	3.00*	2.80	2.84	3.47	3.2
Number of employees	35,326	30,379	27,746	27,000	25,000	24,000	23,000
	1997	1998	1999	2000	2001	2002	2003
Shoe production (mill. pairs)	18	15	14	13	13	8 **	7**
Export (mill. pairs)	14	13	14	12	12	11	8
Import (mill. pairs)	29	31	30	30	36	46	44
Per capita consumption (pairs)	3.13	3.22	2.87	3	3.58	4.25	4.10
Number of employees	21,000	15,000	10,500	10,000	9,500	7,000	5,000**

Data source: Czech Statistic Office, General Directorate of Customs, Statistics of the Ministry

*Down to 1992 the consumption per capita was assessed for the whole Czechoslovakia

**Qualified estimate

roughly 4.1 pairs per inhabitant. The same trends for production and exports are anticipated in 2004. Accordingly, production should not continue to fall but a reduction of import is anticipated with regard to measures that have been taken against China since May 1, 2004, after the Czech Republic joined the European Union.

One of the big positives which China and India have in their favour in the current climate of changing location is their large domestic markets. The new EU members do not have this advantage. Poland is the largest with just 38.5 million inhabitants followed by the Czech Republic with 10 million. The others are much smaller with Slovakia at 5.4 million and the remainder 1.5 million each or less. For the Czech Republic 10 million is a relatively small market for selling shoes. If the manufacturers wish to fill their capacities they are bound to export. A number of manufacturing partnerships with West European partners is seen to develop, as well as the transition to

products with more sophisticated construction, higher utility value and modern design.

Most Czech manufacturers who have been able to cope with the strong local and foreign competition have understood the necessity of specialised products and appropriate marketing. These Czech manufacturers manage to export 70-80% of their production.

Having restructured their production, the Czech shoe companies manufacture shoes with higher value added especially in the following segments: protective, safety and working shoes, but also orthopaedic and high quality children's shoes. High quality lady's and men's outdoor shoes feature in this group as well.

A strong point of the Czech shoe makers is skilled labour, especially in the regions where shoe production is traditional. Its geographic position "in the heart of Europe" can help to do away with some problems, such as concerning shipments of shoes that are intended not only for EU countries but also for the countries of the former Eastern Bloc. Accordingly, no keeping of stock in central warehouses and less finance are needed, as the distribution link from the manufacturer to the customer can be very fast.

While some companies are doing well in the area the overall prognosis must cause concern. In a report produced in March, Roland Berger, the Munich-based consultancy, argued that China is producing better quality goods than competitors in Eastern Europe. The report emphasises the dilemma of European makers wishing to outsource or partner. Logistically and in terms of management of intellectual property staying in Europe is best but in many areas such as cost, efficiency and quality Asia can be better.

Recently the Economist newspaper has indicated that "all eight countries of central Europe that joined the European Union in May, from Estonia to Slovenia, appear to be fascinated by Ireland. They each hope that generous dollops of EU money, eased down with judiciously low corporate taxes, will mean that they can follow in the tracks of the 'Celtic Tiger'—and get rich quick". Not a good sign for the leather industry perhaps, with the last tannery in Ireland having just closed its doors. 🌐