

# *INVESTING IN THE CZECH REPUBLIC*

by

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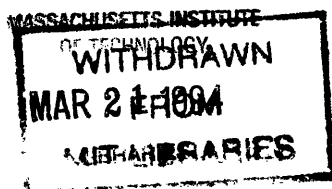
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## **ABSTRACT:**

As not enough information is known about the countries of central Europe and their transformation processes, the objective of the following paper is to present the Czech Republic through an investigation of its latest economic environment, and to show that despite some negative characteristics the country promises large benefits for potential foreign investment. The decision to write the following paper is to dispel the fear, or at least a large uncertainty and suspicion connected with foreign investment in central Europe. This is created predominantly by two reasons. The first reason for this negative image is the lack of understanding of the economic condition in connection with the general character of each country. As I have observed, once those facts are comprehended, the whole issue of investment can be looked upon from a different perspective. The second reason is that eastern Europe is often treated as a single entity, creating distorted perceptions of each country's performance.

This paper would serve as a resource for any potential foreign investor in need of more detailed knowledge of the economic development which took place during 1992 and 1993. I will show that with the current pace of development it is to the benefit of the potential investor to consider both short and long term benefits. This is especially true for the construction industry whose major assets are its people. On the other hand, long term benefits, that many advocated are the only option in particular sectors into which new investments take place. Therefore, it can be argued that short term benefits exist for a potential investor and can be exploited.

An overall look of the investment climate of the Czech Republic is presented, both in terms of Foreign Direct Investment (FDI) and Capital Investment through the Stock Exchange. Specifically, a large part of FDI is directed to commercial sectors rather than technology production. Finally, based on the information presented on the economic environment of the Czech Republic in recent years, I argue that more investment in technological intensive production would be a profitable venture. Specific examples taken from the construction and manufacturing industry as well as from the service sector will illustrate the potential benefits.

The paper is divided into four parts composed of individual sections. The first two parts present the economic environment of the country for 1992 and 1993 with a more detailed look at the governing forces. Continuous comparison between the construction industry and the manufacturing sector highlights the relative developments of the two largest industries. The presentation of the two fiscal years enables an in-time evaluation of the country's economic development, and allows the formation of a basis on which any future investment decisions should be made as long the country is not fully integrated into the western economy.

The third part, discusses the current trends of the new Stock Exchange which is compared with its rival, a sort of OTC market, and prospects of capital investment in both. In addition, a comparison of share prices of construction companies and other companies is made.

Examination of the possibilities of investing at the Capital market, is followed by the examination of possible financial, economic, and operating risks for FDI. Next, possible financial techniques of FDI are presented. Finally, a company active in the construction industry is examined, and a strategy is developed for FDI by means of acquisition or join venture.

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## ***INTRODUCTION:***

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The sudden and peaceful change in 1989 from a “planned” to a “market” economy created certain economic dislocations; but where there is dislocation there is opportunity. The Czech Lands have historically been an integral part of western Europe; politically, economically and culturally. The industrial base of the Habsburg monarchy was located in Bohemia, and Czechoslovakia's GDP in the 1930's was among the highest in the world. As in the instance of other countries Czech lands developed due to its natural resources (coal and iron ore mainly). The country was not, however, developed only in the heavy industrial sector. It was known also for its specialized machinery ranging from weaving machines to heavy industrial machinery and arms. It used to be an industrially and agriculturally developed nation. The end of the Second World War saw almost one third of Czechoslovakia liberated by the Allied armies, and only after Soviet insistence was the country forced to withdraw its application for Marshal plan assistance, thereby losing its chance to participate and integrate itself in the western European reconstruction. The engineering and manufacturing skills have survived, but many companies that should prosper now require considerable re-investment to survive in the new environment. The Czech Republic remains a predominantly industrial economy, compared to the more agriculturally oriented economies of Poland, Hungary, and Slovakia to the east. It offers the potential investor a wide variety of opportunities in many manufacturing sectors. There is no doubt that, properly managed and adequately capitalised, the Czech work force compares favorably to their western neighbors. Since 1990 the pace of economic reforms has been dramatic. Vaclav Klaus, then Finance Minister, and since 1993 Prime Minister of the Czech Republic has insisted on a program of minimizing state subsidies to industry, maintaining a balanced budget, implementing market oriented economic reform, transferring state ownership of industry to private hands, and adopting legislation to encourage and protect business activity and foreign investment as quickly as possible. The country has also been fortunate in the leadership of Vaclav Havel, who has maintained both the trust and goodwill of his constituents, and the confidence of the international community. Thus, the stable political environment, and -as will be shown- the promising economic developments form the best conditions for investment in central Europe.

## ***Part 1:***

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### **MONETARY DEVELOPMENTS DURING 1992:**

#### **OVERVIEW:**

Our examination will start in 1992 when the “Large privatization” process started (where large companies were privatized). The economy began functioning on the basis of market relationships and the Federation divided itself into two independent countries. The following paragraphs highlight the most important developments during 1992 and form the basis on which further comparisons and arguments will take place throughout the paper.

It is important to understand that in contrast to western Europe where economic figures of one year become outdated the year after; in central Europe those figures are very important since they will determine any future developments. Therefore since 1992 could be considered as the “year 0” for the Czech Republic, it is important to understand which are the economic conditions on which further developments will take place. Only then, one can understand what are the differences among the four countries of central Europe, and why one is more appropriate for a certain type of foreign investment than the other. Most importantly, the knowledge of the initial developments in 1992 and 1993 brings an understanding of the domestic environment, and can shape investment strategies not only for the following year, but for as long as those countries will have not achieved a complete integration in western markets. For example, had the foreign investors looked more carefully upon economic parameters in Hungary and Poland during the 1990-92 period (large foreign debts, budget deficits, unstable exchange rates, unemployment, etc.), the foreign investment those countries received would be substantially smaller. Instead, the most important attributes foreign investors were seeking had to do with tax concessions, labor costs, economic growth, and generally short term parameters. Those past developments therefore explain the smaller amount of foreign investment the Czech Republic received in comparison to those two countries, since the Czech Republic (formerly Czechoslovakia) treats foreign and domestic investors the same way. Thus, only during 1993, it became obvious to foreign investors that the

importance resides not within an artificial environment which a subsidiary creates by negotiating better terms with a government. Instead, what is crucial is to develop an investment strategy based on the real economic conditions of a country.

Central Europe is neither east Asia nor south America where investment is based on low wages and government concessions. In central Europe investment has to be based on a current economic situation, which is tied to the initial developments. Nevertheless, those developments, on which each country of central Europe based its further behavior towards domestic and foreign investors has to be understood as more than just mere numbers. It is even more important to see what influenced the development of those numbers, and how they can change in future. Mere numbers would be quickly updated, providing an investor with nothing else than just temporary information. Knowing what shaped those numbers provides an investor with a basis on which an investment strategy adjusted to the local parameters can be based. For example, in western Europe a long history of economic indicators has been established, and predictions from the part of an investor can be made almost solely on a basis of few economic indicators. Central Europe, however, neither possesses a sufficient economic background, nor a stabilized environment. Therefore it is important to identify those forces which shaped the initial economic development of the country (in our case the Czech Republic in 1992), acknowledge that they have more value than the figures themselves, and on the basis of those developments formulate an investment strategy.

Consequently, this is the reason why so much emphasis is given here on the initial economic framework of the Czech Republic during 1992. For the same reason, several not widely known nevertheless important parameters that shaped the overall investment climate are reviewed for 1993. Because there are no past performance data for prior years, therefore only comparisons can be made among industries in the same year rather than from year to year. Information is provided for a wide spectrum of economic sectors. Accordingly an investor can evaluate which sector has a long or short term potential, either through direct investment, or capital investment through the Stock Exchange.

The Czechoslovak economy entered the 1992 in a situation where the basic monetary balance had been reached, and the confidence in the currency was constantly increasing. This was caused mainly by the

positive monetary developments in the second quarter of 1991 (foreign debt, balance of payments, current account, unemployment, inflation, successful "Small privatization", etc.), which created the necessary prerequisites for any future developments. Despite the positive monetary signs, however, the productivity problem remained, and it was already obvious that the transformation to a market economy will take longer than initially predicted.

The most important parameters which influenced a positive development in 1992 were the difficulties imposed on the Czechoslovak exports (primarily machinery, chemicals, food products, construction materials). This decline in exports was a result of the continuing recession in the economies of the EC, the dissolution of the former Soviet Union, and the crisis in the other eastern European countries. Except for the loss of eastern markets, other important parameters include the quotas imposed by the EC on the Czechoslovak exports (steel and agricultural products).

The effectiveness of the Czechoslovak economy in 1992 had not reached more positive results in terms of the GDP and productivity. The transformation process was being delayed by the expected split of the Federation and its consequences. Nevertheless, despite the continuing decrease of the GDP throughout 1992, towards the end of the year signs of revival were reported. Even though the 1992 GDP was 7.1% lower than in 1991, during the second half of the year it rose 0.5% higher than during the same period in 1991.<sup>1</sup> The GDP in 1992 was \$26.1 bil. (\$2,535 per capita)<sup>2</sup> of which 70.2% came from the Czech Republic; Table 1.

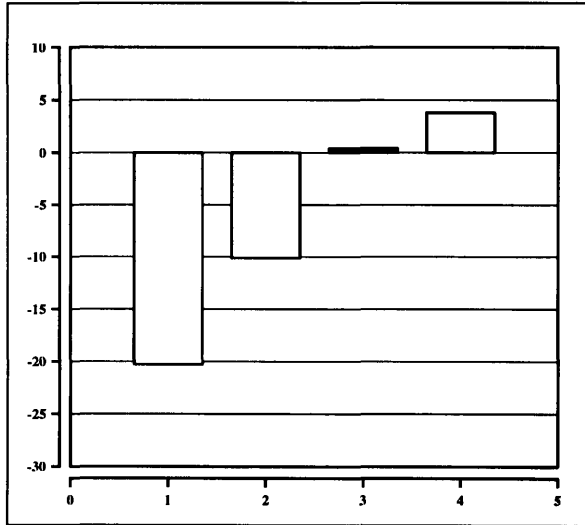
The decreased efficiency of the economy was expected as an inevitable result of the transformation process. The change in this decrease could be seen only towards the end of the year. The increase in the real wages (by 9.3% compared to 1991) and the real income (by 5.00%) of the population supported an increase in consumer demand. During the second half of the year an increase in investment demand was also reported. The increase of the aggregate demand for investments resulted in an increase of industrial production, and of production in the construction materials industry. The development of the private sector whose participation increased not only in the retail sector (65%), but also in construction, services, transportation and industry was also remarkable. In overall numbers, the portion of the

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1. HN 4.14. 1993

2. *CzechInvest*, 7.30.1993





**TABLE 1. GDP in 1992 (change in %) in comparison to the same periods of 1991 (HN 3.11.1993).**

GDP generated by the private sector doubled in 1992 in comparison to 1991.<sup>1</sup>

During 1992, the reorientation of export markets from the former east European countries to western Europe also continued. The amount of imports (increased by 21.6% in comparison to 1991) which exceeded the exports (increased by 7.3%) by a considerable amount during the last quarter, resulted in a trade deficit of \$1871 mil. for 1992. Nevertheless, the influx of foreign direct investment and the favorable condition in the service sector (due to the increased tourist activities) resulted in a Current account surplus of \$225,6 mil.<sup>2</sup>

The most important event of the last quarter of 1992, that had the largest impact on the monetary developments in 1993, was the expected split of the country. It was obvious, from the declarations of the Czech and Slovak governments that the two countries would follow considerably different ways of economic reforms and government politics. The solution process of those differences resulted in a series of expectations and unclear situations, which led to a decrease in the interrepublic trade and disturbances on the money market.

The macroeconomic situation had remained stable during 1992. The exchange rate of the Koruna retained its value (\$1 = Kc 30) towards the currency basket to which it was bound, even after the liberalization of its

internal convertibility. The annual inflation rate measured by the increase of consumer prices was 11.5%. At the same time, however, consumer prices increased only by 6.4%. This difference was created by the imposition of new taxes, the expected new tax law based on VAT and by the expected split of the Federation. The basic targets for stable exchange rate and low inflation of the monetary policy of the Central bank were, however, achieved during the 1992 year.

These results were obviously affected by the monetary developments of the previous years. Starting in the midst of 1991, the monetary situation eased, and during 1992 it lost its restrictive character. Up to 1992, the monetary situation had been influencing the development of prices as well as the demand for foreign currencies. Concerned about large inflation and its consequences, the Central bank imposed strict regulations on commercial banks and companies, causing market liquidity shortage. These regulations consequently affected the balance of payments and the inflation rate. In addition, in 1992, it was possible to perform a significant change in the monetary policy. The Central bank abolished during the year the remaining administrative tools of monetary control (interest rate ceilings for both deposits and loans) and pursued a monetary policy only with indirect tools (controlling the money supply).

## 1. STRUCTURE OF TRANSFORMATION IN 1992 AND ITS ECONOMIC IMPACT.

The political transformation of 1990-91 has caused structural changes in the Czechoslovak economy. Entering the 1992, it was characterized by a deep decrease in its efficiency, an inevitable feature during changes from one economic system to another. In addition, there was a deterioration in the external environment due to the slowdown of the economic growth in the EC, the limited demand from the countries of the former CMEA, the sanctions against Yugoslavia, etc. Household demand had been increasing during 1992 mainly due to the increased income of the population (increased during the year by 17%<sup>3</sup>) which consequently supported higher consumption. Another major influence on the already increasing demand was created by the expected split of the country, as well as the new tax law implemented on

1. HN 4.15. 1993

2. HN 1.17.93

3. EKONOM 15/1992

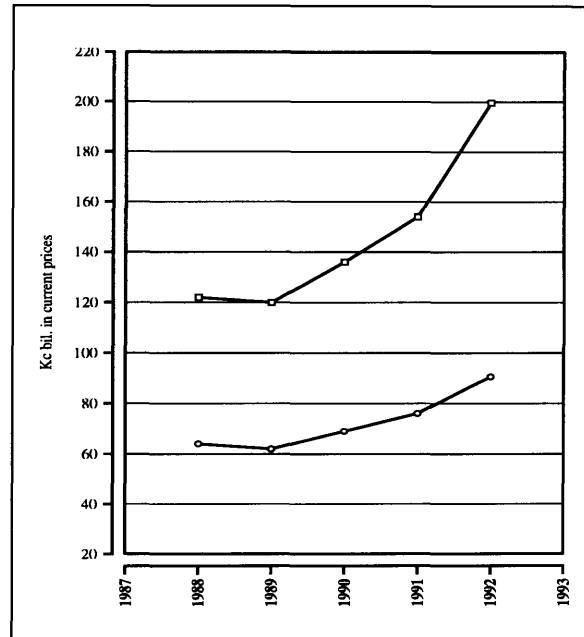
1.1.1993. Measured in volume of retail sales in real prices the household demand in 1992 increased by more than 17%. The income from the tourist industry also played a major role in this development. It reached Kc 37 bil., and increased by 54% compared to 1991. Tourist and entertainment industry contributed to the overall retail sales by about 8%.<sup>1</sup>

In regard to 1991, however, the demand of the public sector (education, security, culture, public health) decreased. Measured in nominal prices, the public sector demand increased by 11%. In real prices, however, it decreased by 3%.<sup>1</sup> It is interesting to point out, that despite the tight monetary policy and decreased government spending the demand of the public sector decreased only by 3%. This can be seen as an early sign of a healthy economy.

The revival of investment demand projected itself to an increase of investment activities and supplies, which increased in real prices by 17.8% compared to the year before. The largest investment boom was reported during the last quarter of 1992, where the volume of investments and investment supplies rose by 54.4% in comparison with the same period in 1991, and by 104% in comparison with the third quarter of 1991.<sup>1</sup>

The largest investments were made in the areas of printed media, metal manufacturing, production and distribution of electricity, gas, steam and hot water, food and drink production, banking and insurance industries. On the other hand, a decrease of investments was reported from the areas of transportation, education, agriculture, and housing. The sharp decrease in new housing construction was caused by complete cuts in government subsidies towards housing construction (whereas previously the government was responsible for the construction of the large housing estates). Thus, the investments in the national economy of the Czech republic reached in 1992 Kc 199.6 bil. whereas the respective number for Slovakia was Kc 90.7 bil., as shown in Table 2.

During 1992 the number of newly started houses decreased by 10%. The private construction sector, however, reported an increase of 3.7%. It can be clearly seen that the inefficient public sector is responsible for not only the decreased volume, but also for the lower productivity. At the same time, the share of the private sector in housing construction was continuously increasing, and in 1992 reached 75% of all the newly constructed houses. During the year many new construction companies were founded, all from



**TABLE 2. Investment in the national economy (HN 4.9. 1993).**

employees of former state companies who either lost their jobs, or left themselves. Nevertheless, the largest increase in demand for the construction industry came from modernization and reconstructions of houses, rather than from new constructions. As will be shown, during 1993 this expanded to reconstructions of industrial plants, and it is expected that by 1995, beside reconstructions, new constructions in housing, industry and infrastructure will help to further increase the demand.

In 1992 there was also an increase in the demand for exported goods. The total volume of exports reported in the balance of payments was, in accordance to the Central bank 7.3% larger than in 1991. Exports decreased only to countries with non convertible currencies, whereas to those with convertible currencies the exports increased by 35.2%. For example, due to the decreased economic activity in the former Soviet Union, Poland and Hungary, the exports to those countries decreased by 44.9% and 22% respectively. On the other hand, the exports to the EC increased by 19.8% in the same period. Changes had been reported even in the structure of exports. The commodities with lower value added accounted for the largest increases (metal, steel, wood, leather, yarns, etc.). The proportion of these commodities in the total exports increased from 30.5% to 35.5% from 1991 to 1992. The export of machinery and equipment,

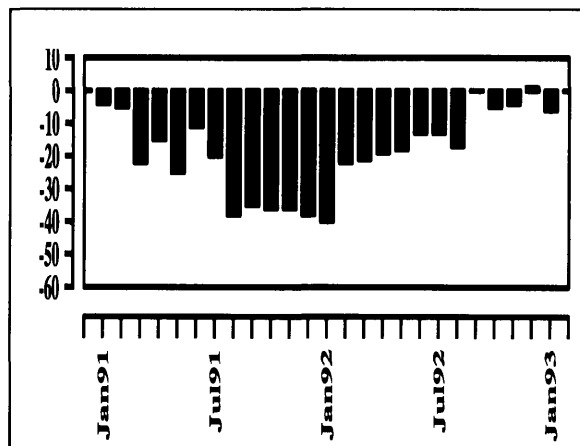
however, decreased for the same period from 28% to 22.8%.<sup>1</sup>

The continuing growth of the aggregate demand resulted in an increase of the GDP (due to inflation), that nevertheless decreased in real prices during 1992 by 7% in comparison to 1991 (the decrease was 16.5% between 90-91). During the 1992 the GDP was continuously growing and during the fourth quarter it was 3% above the volume of the respective quarter in 1991.<sup>1</sup>

The private sector started developing during the 1991. During the same year, the "Small privatization" process started, concentrating mainly on retail trade, services and small enterprises, leaving the industrial sector for the two waves of the "Large privatization" in 1993 and 1994. Even though the effect of the privatization process from the viewpoint of increased effectiveness of the Czechoslovak economy was during 1991 minimal, its real value could be seen in the visualization of the changes in the ownership relations. Thus, the real participation of the private sector, both quantitatively and qualitatively could be only seen towards the end of 1992. It was about 30% in the construction industry, 12% in the industrial production, and 65% in retail trade (the distributed shares from the first wave of the "Large privatization" are not included).<sup>1</sup>

Compared with 1991, the industrial production decreased in real prices by 14%. During the year, however, the decrease stopped and in the last quarter, the first signs of revival were seen. Thus, during the last quarter the volume of industrial production approached the respective numbers for 1991 and towards the end of the year it was 4% higher; Table 3.

It should be noted that the decrease and the revival of the industrial production were not accompanied by any major structural changes in the production process. Rather it should be accredited to the changes in the economic system. Better results (even though below those of 1991) were reached in the areas of mining and treatment of raw materials, as well as in the food industry, whereas the largest decreases were reported from the non-ferrous metallurgy, electrical, electronics and optical appliances industry. It can be seen, that the low value added, and energy demanding sectors of raw materials processing, mining, etc., by showing a revival, increased their share in the overall exports at the expense of a more technology intensive industry.



**TABLE 3. Industrial production (% change over a year ago); JP Morgan 4.23. 1993.**

This can be attributed to their low production costs which make raw materials very competitive in the EC. On the other hand machinery and appliances suffer from lower quality which makes them noncompetitive in the EC countries, and lack of distribution channels which prevents them from being exported elsewhere.

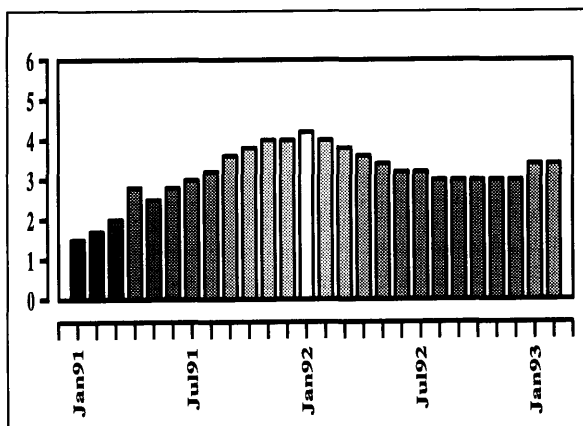
The overall increase in construction production in comparison to 1991 reached in real prices 12.6%. This increase was primarily supported by development of smaller companies. Construction production in real prices was increasing throughout the year, and did not even show the expected 4% seasonal decrease during the last quarter. Interestingly, during December 1992 the increase was 22.8% in comparison to the same period of 1991, something that can be accredited to the new tax law (implemented 1.1.1993), that introduced VAT and effectively increased taxes. The largest increase, however, occurred in construction activities performed abroad. They increased by 100%. Only in Germany, there were about 7000 workers on 400 construction projects which accounted for an income of Dm. 137 mil. to the national economy.<sup>2</sup> Foreign construction, however, accounted only for 8% of the overall construction production. As far as the structure of the construction production is concerned, there was an increase in new construction, reconstruction and modernization in contrast to repairs and maintenance performed during the previous years. The transformation towards more capital and technology intensive projects, shows the better position of construction, in comparison to the rest of the industrial sector, which followed the opposite direction.

1. HN 4.27. 1993

2. HN 3.11. 1993

The cash reserves of state companies (including the privatized companies which, however, still functioned under the old management) had been decreasing throughout the year. By the end of the year the reserves had decreased by Kc 23 bil., or 3.2%. As we will see, this developments resulted in serious liquidity problems during 1993. Despite this decrease, the private companies ended the year with more cash, and therefore in overall numbers the decrease had been Kc 12 bil. or 1.6% for 1992.<sup>1</sup>

The job market was largely characterized by a decreasing unemployment which stopped only in December; Table 4. The number of people interested in finding a job reached 395 000 by the end of 1992, which accounts for little more than 5% (2.57 in the Czech Republic and 10.38 in Slovakia). The unemployment was during 1992 influenced by stricter regulations concerning unemployment benefits, the non market behavior of companies' management still in position from before the privatization process, but also by the correct (given the circumstances) employment politics of the government. The low rate of unemployment in 1992 was created largely due to the over employment (estimated to 350 000 people) in the areas of industry and agriculture, made possible by low wages. In addition, the over-employment is also responsible for the low productivity, to which foreign investors often point as a major obstacle in their investment decisions.



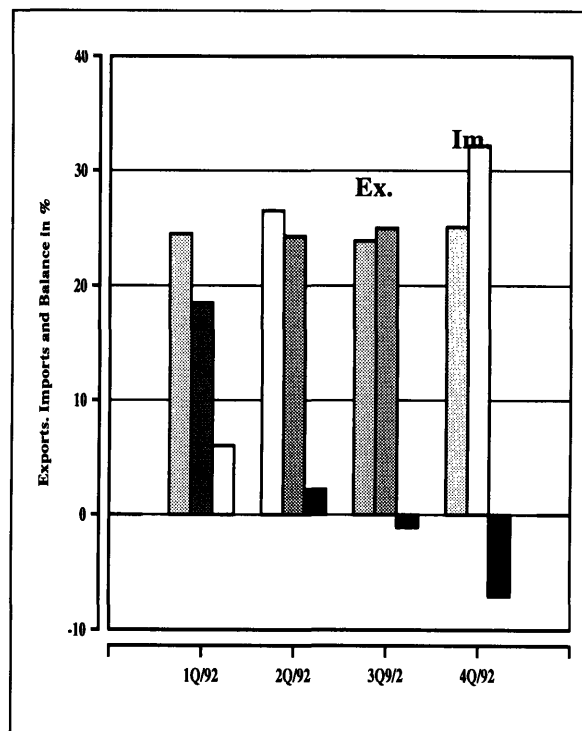
higher than the expenses. Out of this amount 6.2 bil. remained cash and 33.7 bil. were deposited in banks. The larger expenses were influenced again not only by higher incomes, but also by the expectations of the population due to the new tax law. The real income of the population rose during the year by 5% in respect to the year before.

The average nominal wage increased in comparison to 1991 by 20.8%, but due to the lower rate of increase in the living expenses the real wage rose by 9.3%. The increase of real wages thus compensated for their deep decrease during 1991 by 24%. In industry, wages rose by 20.1% whereas in construction the increase reached 21.4%. Interestingly, in construction, productivity rose faster than wages (in comparison with 1991 to 125.4%) whereas in industry even though the wages rose, the productivity decreased (97.7% in comparison with the year before). Again, what can be seen is that the construction industry not being restricted so much by quotas, and being in demand domestically was able to outperform the rest of the industrial sector.<sup>1</sup>

The foreign trade of the Federation was characterized by a slight increase of exports and a considerable increase of imports especially in the fourth quarter. One of the characteristics of last year's foreign trade is that 98% of all the transactions were made in convertible currencies (the number for 1991 is 80%). Other characteristics are the orientation of exports towards market economy countries and the change in the structure of exports (less exports of machinery and more of semifinished goods and raw materials in contrast to increased imports of machinery and decreased imports of fuels). During the year, external parameters as the decrease in trading with the former Soviet Union due to its lack of convertible currencies, the embargo imposed on Yugoslavia and the continuing recession in the EC influenced negatively the foreign trade. On the other hand, as positive parameters could be considered the signing of the association treaty with the EC, which asymmetrically favored exports over imports (higher quotas, lower tariffs on exports to the EC). The favorable export condition during the first half of the year projected itself on increased exports of steel to the EC, something, however, that did not last long since during the second half of the year protectionist measures from the EC resulted in a 37% decrease of

steel exports. The internal factors that influenced the foreign trade were mainly protectionist measures against agricultural and food products, where the import tax increased from 5.3 to 7.3%. The increased imports were influenced (besides the increased demand for transportation equipment and machinery) also by the VAT, to be imposed at the beginning of 1993 as part of the new tax system. This resulted in a tendency to accumulate inventories with less expensive imported goods. Finally, the increased imports during the last quarter were due to speculative reasons before the break of the Federation on 1.1.93.

The deficit in the trade balance reached in 1992 (in accordance to the Central bank) \$1871.2 mil, decreasing the surplus of the Current account balance. The slight surplus in the trade balance during the first half of 1992, transformed itself into a deficit with an increasing rate, mainly during the last quarter. In addition, accordingly to the Central bank, and only as far as convertible currencies are concerned (98% of trade), the trade balance showed a \$1575.6 mil. deficit in 1992. Exports increased by 35.2%, imports by 46.3% and the trade deficit increased by \$1128.2 mil. in respect to 1991.<sup>2</sup> The development of the trade balance in% per quarter is shown in Table 7.



**TABLE 7. The Trade balance during 1992 (HN 4.27.1993).**

1. HN 2.16. 1993

2. HN 4.27.93

The exchange of goods with market economy countries rose by 21% as far as exports and 26% as far as imports are concerned. In the case of Germany for example the relative numbers are 20% and 26% which makes it the largest trade partner of the Czech Republic. Also, large increases in these numbers are reported with the USA and France. Finally, the portion of trade made with market economies increase to 74% and 68% for export and imports respectively. In contrast to the above, there had been a decrease of trade with non market economy countries by 36% in exports and 14% in imports. With the second largest trade partner (the former Soviet Union) the decrease was 45% in exports and 10% in imports. The exchange of goods with this partner is performed mainly on the basis of barter trade. In the structure of the exported goods prevailed the 1991 trends, with a decreasing number of exported machinery, transportation equipment and increasing number of goods with lower value added as semi-finished goods, fuel products and raw materials. The association treaty signed with EC allowed for an increased exports of construction materials. In the case of rolled steel for example the exports increased by 7% or \$103 mil. Cement, asbestos, and other steel products were also exported in increasing quantity, and thus helped to compensate the decrease in exports (\$500 mil.) of machinery.

As far as the structure of imports is concerned, in comparison to 1991 there was an enormous (38% and 49% only for the Czech Republic) increase in imports of machinery and transportation equipment. Follows an increase in imports of fuels. The dynamic development of services had as a result an increased demand for buses, trucks, airplanes etc. Imports into the industrial section, were not significant, and did not have a significant impact on the modernization of production. The most significant imports had however been made to construction and food industry and to the printed media. In the consumer products area, the largest increases were reported in the imports of food, tobacco, cosmetics, chemical products, electrical appliances, office supplies, textiles etc. which resulted in a decrease of individual imports by 28%.

The "Small privatization" process which aim was to create small and medium entrepreneurs was completed. Until the end of 1992, 32000 small enterprises were sold with a total cost of Kc 46 bil. A decisive step in the transformation of the Czechoslovak economy was the completion of the first wave of the "Large privatization" process. From the total property of Kc 299 bil. assigned for the first wave of the "Large

privatization", 278 bil. or 93% was privatized. Besides the coupon method, other means of privatization as direct sale, public competitions and public tenders were used. At the end of the year, the Fund of National Property of the Czech Republic acquired by the sale of shares Kc 26.8 bil. and the respective slovak Fund Kc 6.6 bil.

### **SOUND ECONOMIC TRANSFORMATION CREATES A FIRM BASIS FOR FUTURE DEVELOPMENTS:**

In light of the continuing recession in the EC, the loss of the eastern markets, and the anticipations for the split, the 1992 economic results should be regarded as positive. Investment in the Czech economy increased, the GDP started growing with a larger contribution from the private sector, and the industrial production showed the first signs of revival. The construction sector in particular showed the first signs of what is expected to be a market with large growth, not only in the Czech Republic, but throughout the central and eastern Europe. This was observed as early as in 1990 by German companies producing construction materials, who rushed to acquire cement, asbestos, and ceramics producers throughout the country. The unemployment was increasing only slowly, and fear of massive layoffs passed. Inflation was influenced mostly by the following parameters: devaluations, subsidy cuts of 1991, and the expected split, all of which brought sharp and one time increase in prices. Thus, wages increased to compensate for the undervalued currency, which resulted from the income loss due to the abolishment of state subsidies, and the devaluations of 1990 and 1991. In turn, this process boosted exports. However, the devaluations were so deep (see page 50), that despite the increases in wages, export products were able to be priced competitively. Consequently, in 1992 lower wages should not have been the primary reason for foreign investment. This is especially true for central Europe (in contrast to eastern Europe, south America, or east Asia), since low wages there have only a temporary effect.

The slight trade deficit was easily covered by other incomes of the Current account balance. However, the composition of exports which favored raw materials, and semifinished goods, instead of goods with higher value added remained problematic. This development showed that low costs still placed a more important

role than product sophistication and quality. Imports were focused mostly on items which did not help to modernize production technology and consequently did not help to improve the export composition in favor of higher value added goods.

The industrial production suffered from the unfinished privatization. Even though it showed some signs of revival, this development was interrupted in early 1993 as we will see in the following part. This could not be attributed only to the quotas imposed by the EC (which had impact mostly on low value added products), but also to the lower exports of machinery. Except for the loss of the former eastern markets where most of the machinery used to be exported, another reason for the decreasing exports of machinery could be sought in the insufficient imports of technology on which further development and production could be based. Czech companies are capable producing world class, well engineered machinery; yet due to insufficient technology in material production their products have inconsistent quality and are therefore difficult to sell in the EC. In spite of the quality problems the ability of Czech producers to find new markets especially in the EC is commendable. A foreign investor should acknowledge therefore that in the long terms engineering intensive production make sense in the Czech Republic. In the short terms, one could take advantage only of the lower costs for modernization and investment to a production facility.

## **2. MONETARY DEVELOPMENTS IN 1992.**

Having an export economy, it was important for the country to be able to substitute its lost eastern markets. However, due to the insufficient quality of its products, this could be achieved only if the export prices would be sufficiently lower than those of other western competitors. Also, in order to attract foreign investment, the country had to show a stable exchange rate. Both of the above parameters are largely dependent on inflation. Therefore, in addition to sound economic transformation, correct monetary politics had to be maintained. Only then the whole process could be controlled.

During 1992 the basic strategy of the Central bank was to keep stable the internal buying power of the Koruna, and consequently to keep inflation below the 12% limit. The stabilization of the buying power was also one of the prerequisites to keep stable the

exchange rate. The Central bank focused also on the development of financial markets, (or the introduction and proper functioning of monetary instruments) as a necessary condition for the proper control of the monetary development. The development of inflation and the extraordinary stability of the exchange rate showed, that the Central bank succeeded, in the given conditions, to meet the pre-specified monetary targets. This success also allowed to alleviate the restrictive character of monetary politics. Even though there was a slow-down in the positive monetary developments towards the end of the year (due again to the split of the Federation and the new tax law), which had as a result increased inflation and decreased hard currency reserves, in general the monetary development during 1992 followed the pre-specified program. The inflation remained at 11.5% and the money reserves (with the exception of two months) remained at the pre-specified quantities. Only the real output did not reach the expected 6% but only 2.8% (4 Q 1992/4Q 1991).

During the year, the Central bank had to react to two major factors that were influencing the monetary development. The unexpected increase (except at the end of the year) in foreign assets, and the too large free assets of the large banks in the developing interbank market. The Central bank reacted to this development by a decrease in the volume of refinancing loans issued, with emission of treasury notes, and towards the end of the year by an increase of the required minimal currency reserves of commercial banks (from 8% to 9% for time deposits and from 2% to 3% for demand deposits).

The changes in the discount rate acted (due to its low influence on refinancing) during the year more as a signal from the Central bank towards the commercial banks. The discount rate was changed three times, twice decreased and once increased. In April it went from 9.5% to 9% in August to 8%. The two decreases aimed at small entrepreneurs and their possibility to obtain loans. Towards the end of the year the discount rate increased again to 9.5%. The increase was a reaction to the increasing interest rates, the monetary situation at the end of the year, and the expected developments in 1993. From the viewpoint of monetary control, the 1992 was the year where it passed from a direct to indirect form. After the abolishment of interest rate ceilings on deposits in April, and interest rate ceilings on loans in October (for the big commercial banks), the Central bank started controlling the monetary development only indirectly,

adjusting the money supply on the basis of monetary analysis.

Whereas the strict monetary policy resulted in limited money supply and high interest rates on loans (insufficiently affected by discount rate changes), it also supported the exchange rate. Thus, in the area of foreign exchange, the basic instrument for 1992 was the stable exchange rate of the Koruna. The trade balance developments did not call for any change in the exchange rate. Only two changes regarding its computation were made during the year, which, however, did not have any impact on the exchange rate itself. First, during the conversion of payments into freely convertible currencies with the former eastern block countries, the currency basket was adjusted in favor of the USD. In addition, from the end of September, the so called "fixing" of the currency was introduced. In fact, it meant a more accurate computation of the exchange rate since parameters like internal demand for hard currencies, and changes in monetary politics were introduced, in addition to the fluctuation of the foreign currencies to which the Koruna was bound. Finally, the positive monetary developments in 1991 allowed for an increase in the limit of foreign currency that can be exchanged per year and per capita, to be increased by 50%, and the consumer import tax to be decreased from 10% to 5%.

### CURRENCY RESERVES DEVELOPMENTS:

The development of currency reserves during 1992, was in accordance to the monetary program. The total increase in currency reserves during the year was Kc 141.7 bil. (an increase of 20.3%) and concluded in total reserves of Kc 839.9 bil.<sup>1</sup> The total increase of currency reserves during 1992 resulted from an increase in both internal and external sources of capital; Table 8. The faster rate of increase, however, occurred in the external sources. In spite of the decrease in foreign assets towards the end of the year (due to the split and the new tax law), they contributed in an increased number to the growing currency reserves when compared with 1991. In absolute terms, however, in the emissions of new loans were dominated by domestic sources of capital. From a structural point of view, during the 1992, the tendency in a faster growth of M2 over M1 continued. Whereas

M2 grew by 20.3%, M1 grew by 15.7%. This development was caused by the increase in foreign currency and time deposits, which contributed by 58.6% to the overall growth of money reserves.

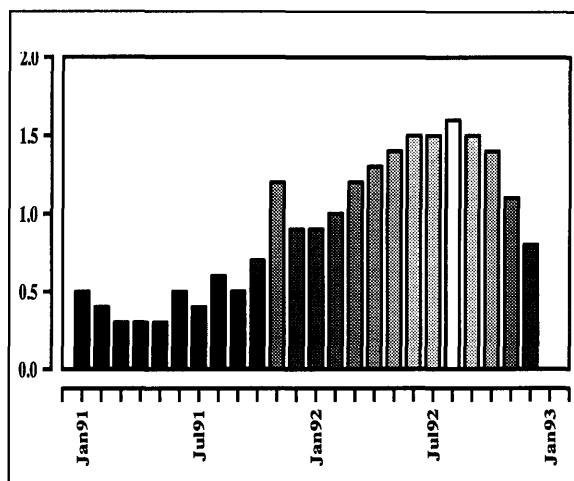


TABLE 8. International reserves of the Central bank in \$excluding gold (JP Morgan 4.23.1993).

### POPULATION:

Even during 1992 the population kept most of its savings (88.9%) in Koruna, with domination of time deposits. During the year, however, the increase of deposits in foreign currencies continued. This was a result of increased tourist activity in the country, employment abroad, the expected influence of the split together with the new tax system on the monetary condition. Thus, whereas the deposits in Koruna grew by 11.1%, the foreign currency deposits grew by 99.6%. Consequently, by the end of the year the foreign currency deposits increased by 4.7% their portion of all the money assets of the population. In addition, the above mentioned expectations, influenced the savings of the population, which decreased by 5.8% by the end of the year. Nevertheless, there is a constant tendency towards savings, both in the local currency and in hard currencies. Thus, deposits in 1992 and 1993 grew by about 10%.<sup>2</sup> This tendency towards savings, in addition to the increased liquidity of banks, shows that the lack of sufficient liquidity on the market is associated not only with the restrictive monetary policies adopted, but also with the cautious credit politics adopted by banks.

1. HN 4.27.1993

2. EKONOM 39/1993



## LOANS:

The overall emission of loans into the economy is a weighted factor of loans to businesses and population, which during the year increased by 18.3%. Loans to the government including foreign borrowing increased by 80.2%, something that represents an increase of 29.5 bil. The Fund of National Property ended the year with a surplus of 23.8 bil. (whereas in 1991 it ended the year with a 13.7 bil. deficit). The rate of emissions culminated with the economic quarters, with the largest increase during the third quarter. As far as sectors are concerned, the private sectors' increasing portion of overall loans reached 25.9% at the end of 1992 (in 1991 the number was 9.2%). As shown in Table 9, loans for privatization increased during 1992 by 114,6% or Kc 21.2 bil.;

	31.12.91	30.9.92	31.12.92
Total	18.5	35.8	39.7
"Small privatization"		28.8	26.0
"Large privatization"		7.0	13.7

**TABLE 9. Loans for privatization in Kc bil (HN 4.27.1993).**

During 1992, however, there was a transfer of focus from the small to the "Large privatization" process. This can be viewed also in the structure of loans for privatization, where the number of long term loans is growing, even though most of them are still middle term loans; Table 10.

	31.12.91	30.9.92	31.12.92
short term	4.3	5.0	5.5
mid term	70.7	61.2	57.6
long term	25.0	33.8	36.9

**TABLE 10. Loans for privatization in % (HN 4.27.1993)**

As far as companies and individuals are concerned, during the year the fastest growth was also observed in the mid term loans (59.3%), with the short term growing by 10.1% and the long term by only 3.4%; Table 11.

In the manufacturing industry the loans increased by 3.2%; 18.2% increase was reported in the commercial sector and the hotel industry; and 16.8% in the construction industry. Decrease occurred in agriculture (2.1%), mining (7.6%), electricity producing (3.4%) and transportation (19.6%). The

	31.12.91	30.9.92	31.12.92
short term	38.8	38.2	36.8
mid term	18.4	24.0	25.1
long term	42.8	37.8	38.1

**TABLE 11. Loans to companies and individuals in % (HN 4.27.1993)**

largest loans were given to the manufacturing industry (31.0%). Follows agriculture with 5.9%, mining 2.7%, energy producing with 4.0%, construction industry with 2.8%, commerce and tourist industry with 18.6%. As will be later shown, these increases contributed largely to the development of the liquidity problem in 1993, when companies were not able to collect their receivables and repay debts. Loans to individuals increased during the year by 19.9% (Kc 1.0 bil.). 84.4% of this increase was made by the Czech and Slovak Savings banks and 15.6% came from other institutions. The increase was mostly due to the credit made by the Savings banks to individuals, who invested the money through the Savings' Investment Fund during the first wave of the "Large privatization" process. Large interest occurred also in the loans for private house construction. Finally, 75.4% of the loans were long term.<sup>1</sup>

The internal debt of the Federation towards the banking system increased during the year by Kc 7 bil. or 90.7%, to reach Kc 98.8 bil. by the end of the year (not including foreign loans). Out of this number, Kc 32.1 bil. was Federation's debt, Kc 4 bil. was attributed to the Czech Republic and Kc 0.9 bil. to Slovakia. Finally, the internal debt increased from 5.3% of the GDP in 1991 to 9.8% in 1992.<sup>1</sup> The main reasons which influenced the increase of the internal debt are:

- The deficit of Kc 6.6 bil. in all government budgets.
- The issuance of Kc 14.7 bil. in government bonds.
- The decrease of financial assets of the Federation by Kc 19.3 bil. Those were used for a guarantee fund for the debt issuing banks, and in order to solve the liquidity problem of the Czechoslovak Commercial Bank (a bank which during the past monopolized the foreign trade of the country).<sup>2</sup>

The above negative factors were compensated by a better condition of local budgets, state funds and republics' financial assets (a total of Kc 3.6 bil.). The new government debt to the banking system was

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financed through government notes and bonds issuances. During 1992, 42 emissions of government treasury notes were realized through the ministry of finance, with a value ranging from Kc 1 bil. to Kc 11 bil. They were sold in accordance to the American Auction form with collaboration of banks. Loans from international institutions were accepted in order to strengthen the foreign currency reserves, and were sold by the Central bank in accordance to regulations governing the internal convertibility of the currency.

## THE BALANCE OF PAYMENTS:

The developments in the balance of payments occurred during the year in two parts. Whereas during the first half it was positive, during the second it worsened under the expectations of the split. Thus, during the first half, the trade balance and the current balance accounts were positive. In addition, since the flow of capital in convertible currencies was balanced, there was an increase in foreign currency reserves (by \$801 mil. for the first half).

During the second half, and after the June elections the balance of payments developed under the expectations of the Federation split. This influenced domestic as well as foreign investors. Expectations of domestic businesses influenced by the uncertainties about the currency union, devaluation of the Slovak currency and high inflation due to the VAT, resulted in increased imports, and transfers of currency reserves from the Central bank to commercial banks. Foreign investors, on the other hand, demanded an immediate or in advance payment of their receivables. In addition, during the last quarter there was a decrease of direct investments into the economy which together with the above mentioned reasons resulted in a decrease of foreign currency reserves not only of the Central bank but of the whole bank sector; Table 8. The small surplus in the balance of payments account, even though it had been decreasing, could be maintained even during the third quarter. With the increase of imports during November and December, the balance of payments could not be compensated from the tourist industry and the deficit rose to \$1016 mil. Thus, the deficit in the balance of payments influenced the Current account balance which surplus decreased during the second half by Kc 16.3 bil. to Kc 6.4 bil. (\$226 mil).<sup>1</sup>

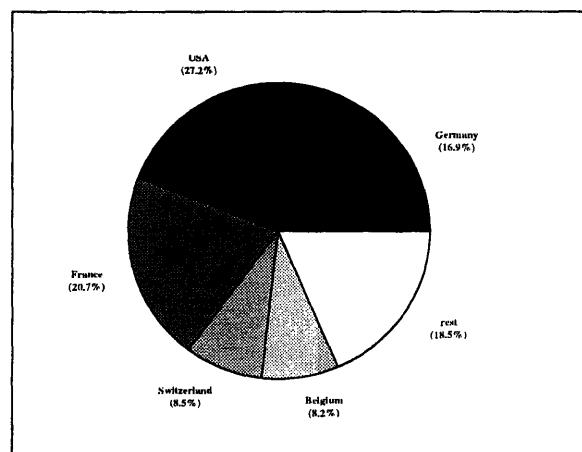
As mentioned before, the main reason of the small surplus of the Current account was during 1992 the balance of services. Its surplus increased during the

year by 91% (\$825 mil.) to reach Kc 46.7 bil. (\$1652 mil.). A major impact on this increase had, except for the tourist industry (\$660 mil), also income from transportation (surplus of \$984 mil).<sup>1</sup>

The capital account results show a capital inflow of Kc 1.1 bil. (\$41 mil.) due primarily to the direct foreign investment and loans from international institutions. This amount was, however, almost equalized by outflow of short term capital.<sup>1</sup>

The inflow of FDI during the year increased by 80% and reached \$1.1 bil. The largest increase was reported during the third quarter (\$0.5 bil.). The source of this capital was mainly the income of the Fund of National Property assigned with the privatization of state enterprises. 90% of the FDI was realized in the Czech republic.<sup>1</sup>

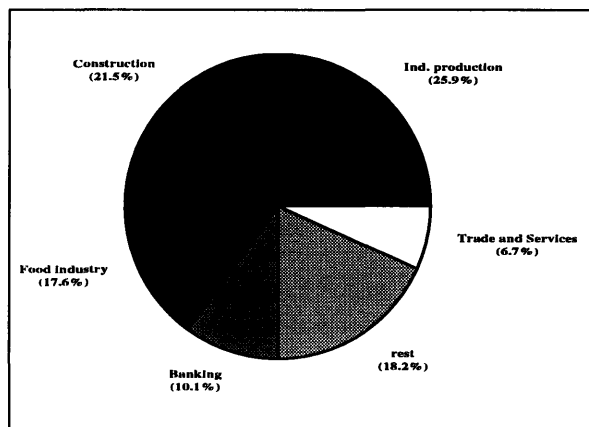
Until the end of 1992, the total FDI by country of origin was the following: Germany 38.5%, USA 20.5%, France 13.9%, Austria 6.9%, Belgium 6.8% and the rest 13.4%. Table 12 shows the respective numbers for the year 1992 only. On the other hand, as far as targeted sectors for investment are concerned, the numbers for up to 1992 are the following: Transportation equipment 26.3%, Industrial production 18.3%, Construction 13.7%, Food industry 10.9%, Banking 9.9% and rest 20.9%. For 1992 only, the investment by sector is shown in Table 13.



**TABLE 12. FDI by country of origin (HN 3.17.1993).**

From international institutions the Federation borrowed \$897 mil. From this, it was \$284 mil. from IMF, \$331 mil from the World Bank, \$232 mil. from the EC, and \$50 mil. from the G 24 group. These loans were taken mainly during the first two quarters,

1. HN 3.17.1993



**TABLE 13. FDI by sector invested  
(HN 3.17.1993).**

because towards the end of the year the economic situation and the currency reserves were in a stable condition. For this reason, the already arranged third and fourth part of the Stand-by loan from the IMF (200 mil. SDR) was canceled.

The expectations of the split reflected in the international reserves of the Central bank which decreased by \$920.8 mil. during the second half, and caused a decrease of \$120.1 mil. for the whole year to \$1231.4 mil. This amount was enough to cover imports for 1.2 months. Despite the \$1082.6 mil. decrease in the international reserves, there had been a \$1080.1 mil. increase in the banking system due to the deposits of hard currency for FDI, and the transfer of reserves from the Central bank to commercial banks. At the same time, there was a \$900 mil. decrease in the hard currency debt of the banking system to \$1626 mil.

The aggregate debt of the Federation, after the \$0.4 mil. increase during the first half to \$9.8 mil. ended finally the year at \$9.5 mil., due to a decreased needs for loans, prompt repayment of previous loans and prompt payment for the new imports. In addition, debts from bond issuances by the Japanese company Nomura, German Commerzbank AG and Nippon Credit Bank Tokyo (total of \$109 mil.) were repaid in advance. Debt service from medium and long term loans was during 1992 11.7% of the years' export of goods and services (in 1991 the number was 11.2%). As will be shown, the foreign debt further decreased during 1993.

## THE STATE BUDGET:

The basic intentions of the economic politics for 1992 attempted to minimize the decrease of

productivity with balanced budgets, to minimize inflation with low government expenses tied to the GDP, and to continue with the transformation process with decreased state intervention to the economy.

The proposed balanced government budget did not account for changes which would influence the budget revenues. On the contrary, in the case of lower economic activity (which took place) there would be a decrease in the budget's expenses. In order to secure a balanced budget, a series of measures were implemented, among them a regulation which would influence budget expenses. In addition, the 1992 budget entered the year with a 1991 deficit of Kc 18.6 bil. (of which Kc 14.7 bil. of the Czech republic).<sup>1</sup>

The realization of the budgetary and financial politics were during the year difficult due to the conflicting interest of different economic features. Thus, there was a conflict of the decreasing productivity on the one hand and the inflation on the other. The whole situation was made more difficult by the increasing political pressure on the split of the Federation which weakened and restricted the influence of the federative authorities. The evaluation of a restrictive budget in an economy under transmission on the basis of a deficit or a surplus is not accurate, neither sufficient. For example, against the abolishment of the government subsidies stands the need of the government to spend more on the restructuring of the economy, on the protection of the environment, etc. On the same hand, transfers to the population can not be restricted since against an economically unequal social system stand the need for new job creation, unemployment benefits and other social benefits. Despite the above mentioned difficulties it is possible, however, to evaluate the results of the budgetary politics (in the given monetary and economic situation) as positive.

## FISCAL POLICY RESULTS:

In accordance to the latest figures, a Kc 16.6 bil. government budget deficit was reported for 1992, from which Kc 7 bil. belonged to the Federation, Kc 1.7 bil. to the Czech Republic and Kc 7.9 bil. to Slovakia<sup>2</sup>. The development of the government budget was positively influenced by a change in the fiscal policy which improved the budgetary results by Kc 9 bil. during

1. HN 4.27.1993

2. HN 4.27.1993

1992. Another factor which influenced positively the development of the government budget was the strict regulation of expenses imposed on the budget from the beginning of the year, which, however, respected social needs. With respect to the limited means to assure a balanced budget with restricted expenses, the Financial Board decided in July to increase the revenue tax. This was possible mainly because of the extraordinary high income of companies generated by the liberalization of prices and cut of subsidies.

The overall revenues of the budget was set to be Kc 497.1 bil. for 1992, realized by 97.8% (or -Kc 10.9 bil. whereas in 1991 it was -Kc 24.1 bil.). If the income is divided into the three respective sectors, than the Federation realized the income by 92.1%, the Czech republic by 100.6% and Slovakia by 98.6%. The largest part of the income was realized from the tax on income and revenue.

Thus, the revenue tax brought an income of Kc 125.8 bil. and was realized in the Czech Republic by 86.7%. The income tax on the other hand contributed an amount of 103.9 bil. and was realized by 89.9% in the Czech Republic. The negative development of this number is associated with the continuing privatization and restructuralization, and with continuing loses of state owned enterprises. In addition, the increasing medium and small entrepreneurial sector did not attribute to the increase of GDP, since it was able to take advantage of less strict tax laws. The tax imposed on wages, on the other hand, was realized by 116.8% which is about Kc 10 bil. more than estimated. It was influenced mainly by higher taxes imposed on wages above Kc 10 000, and new legislative and technical manner of tax collection.

The total expenses of the government budget were Kc 502.9 bil. or 101.2% of the budget. From this number 97.3% is the Federation's contribution, 101.3% from the Czech Republic and 105.3% from Slovakia. The largest expenses were induced mainly by the need to finance the unfinished construction works started before 1990 (an expense Kc 6.7 bil. larger than estimated) and expenses associated with social needs of the population<sup>1</sup>.

## **CONTROLLED MONETARY POLITICS SUPPORT A STABLE INVESTMENT CLIMATE:**

From the monetary point of view, the developments in 1992 could be characterized also positive. The debt

of the country was low and the inflation kept under control. This situation provided foreign investors with an opportunity of a longer term financial planning. The exchange rate kept its characteristic stability, currency reserves increased despite the small trade deficit, and time deposits rose despite uncertainties over the split. For foreign investors, the increasing foreign exchange meant protection against repatriation of capital, dividend payments, import payments, etc. On the other hand, the increased savings of the population provided more opportunities for domestic financing. Emission of loans went up, but the increase would prove to be insufficient in 1993 when more and more companies elect to invest in their production facilities or to refinance older loans. In addition, the increased emissions of loans during 1992 created many problems in 1993 and 1994, because there were not any clear criteria as to the eligibility of a company for a bank loan. Thus, bank loans were therefore given to many companies, something that resulted for many of them in debt servicing problems (see page 38).

Foreign direct investment showed a large increase in 1992 but unfortunately a major portion of it was targeted for commodity production and the trade sector, rather than industries where new technologies were needed. Those new technologies could consequently support exports and change the export structure. The government budget showed positive results despite a slight deficit caused primarily by decreased revenues of the Federation. The previous data have shown that even during the early transformation period the monetary policy was under control. The only significant problem was the restricted liquidity of the market. The limited money supply of the Central bank had, however, both positive and negative results. On the one hand, it kept inflation down and forced companies to cut costs and increase productivity. On the other hand, domestic capital available for investments was low and credit was expensive. Foreign subsidiaries should, however, be able to take advantage of their parent companies credit standing, and finance their operations by raising debt on the domestic market.

### **3. FINANCIAL AND INTERBANK FOREIGN CURRENCY MARKET:**

#### **MONEY MARKET:**

The development of the money market during the year was influenced by three major factors:

- the continuing high demand for loans from enterprises, and increasing demand of funds from the government,
- the unexpected high influx of foreign assets (exception is the end of the year), and
- the unbalanced liquidity in the banking sector, characterized by an excess of assets in the large banks in comparison with the small ones.

The Central bank reacted to this development with a reduction of the internal money supply. This was achieved by a decrease in the available refinancing loans, (during the second half) by an emission of Central banks' notes, and by an increase in the required minimal reserves of commercial banks. Thus, the large commercial banks (constrained until September by a limit on loans they could provide) preferred to purchase treasury notes, rather than to trade on the interbank market, and supply other banks with excess capital. The lack of confidence of the five large banks towards the smaller ones contributed also to this development, since the large banks limited their interbank deposits in smaller banks. The Kc 168 bil. treasury notes were thus easily sold, with problems reported only towards the end of the year. Their interest was 7-12.5% for the Czech and up to 16.5% for the Slovak notes.

However, since the large banks continued to have an excess of liquidity, and the amount of refinancing loans was restricted, they started to lend to smaller banks and the interbank money market started to develop. These changes on the money market consequently increased the riskiness of the smaller banks (which had no limit imposed on lending), that were supplied from the excess liquidity of the large ones. For this reason the Central bank decided to issue additional three emission of one month treasury notes, each of Kc 2.5 bil.

The increase of demand in the interbank market (mainly from the small commercial banks), resulted in an increase of interbank interest rates. Thus, at the end of the year, the average interest rate of interbank

deposit was 12.92% (an increase of 0.99% in comparison with December 1991).

Considerably larger increase occurred in the interest rates of refinancing loans, which reached towards the end of the year 20%. Mainly the smaller banks with low amount of deposits from non banking subjects were dependent on this source. In addition, the restriction in the volume of refinancing loans imposed by the Central bank was associated by gradual changes in the refinancing system. Thus, more market oriented auction forms of refinancing were introduced (1-7 days and 1-3 months auctions).

In spite of the increase in the interest rate of refinancing loans, and interbank deposits, there was not a consequent increase of the average interest rate on loans for the clients of commercial banks. On the contrary, during 1992 this interest rate decreased by 0.63% (computed on the basis of the average interest rate during the year). The explanation can be seen in the fact that the interest rate is defined mainly by the large commercial banks, which are able to obtain the needed capital more cheaply than the small banks. On the other hand, the small banks are largely dependent on refinancing, and the interbank deposit trade. Most of the large banks thus, reacted to the decrease of the discount rate with a decrease of their interest rate, something that was not true for the small banks.

In the same way, the interest rate on deposits decreased in comparison to 1991 by 1.3%. Towards the end of the year, however, commercial banks started (under the situation developed on the money market) to announce an increase of interest rates on loans. This development will be apparent only during the 1993, with increased spreads of the five large banks.

The faster decrease of the average deposit interest rates, in comparison to the interest rates on loans led to an increased spread revenues of commercial banks during 1992 and 1993. These sources of capital are to be used (in accordance to the banks), however, to strengthen the reserve funds of all the commercial banks that have lent during the past to enterprises. Because of the implementation of the bankruptcy law, a large strain is expected on the reserve funds due to the write-offs of unpaid loans. On the other hand, lending has become too expensive, and many companies are seeking loans from abroad. Foreign investors have adjusted to this development by issuing short and medium term debt instruments, secured by their parent companies, and are therefore able to finance under much better terms.

## **THE CAPITAL MARKET:**

The capital market functioned during the year as a temporary secondary market, serving more as a preparation of banks and other shareholders for the future trading on the Stock Exchange. From the viewpoint of trading frequency, volume traded, and institutional and legislative features, it could be characterized as undeveloped. Therefore, its faster development was connected to the time when the privatization shares would be distributed to individual shareholders, and Investment Funds. During the year, many new laws concerning its function were established and the Stock Exchange transferred itself to a stock company. Since there were not many shares available, bonds of major commercial bank, and government bonds were the predominantly traded securities. Towards the end of the year, the largest volume traded was reported (almost Kc 10 mil.), for the one and a half year of the secondary market existence. The government bonds issued during the year aimed at raising enough capital to cover the expenses associated with the construction of state housing which had to be completed. The volume of this issue was Kc 8.7 bil. for the Czech Republic and Kc 4.2 bil. for Slovakia. This was the last time when the state financed housing construction, and as already mentioned (page 10), the result was a steep decrease in the number of new apartments completed.

## **INTERBANK FOREIGN CURRENCY MARKET:**

The interbank foreign currency market was securing during 1992 the proper functioning of the internal convertibility of the Czechoslovak currency. Besides the Central bank other (22 Czech and 4 Slovak) commercial banks were participating in foreign exchange operations. Until September the trading was being made in accordance to the rules of interbank foreign currency market. Thus, the basic priority of the participating banks was to obey the rules of foreign exchange liquidity, or to maintain a proportion of assets to liabilities in a range from 0.85-1.05. In the case of decrease of this proportion below the lower range, the commercial bank had to purchase hard currency from the Central bank. If the proportion would exceed the upper range the opposite would happen. The prices on the interbank market were set as the mean price  $\pm 0.5\%$  between the Central bank and

any commercial bank, and the mean price  $\pm 1\%$  among all commercial banks.<sup>1</sup>

However, by the end of September the rules of foreign exchange liquidity were abolished, and the system which defined the prices used in the interbank trade was changed. The rules of foreign exchange liquidity were substituted by limits on open foreign exchange positions (short-long), which should not exceed 30% of a banks' capital basis. This new system was supplemented by a daily fixing of exchange rates of freely convertible currencies towards the Koruna. Thus, the daily exchange rate was computed on the basis of change of the exchange rate of currencies included in the currency basket towards the USD,  $\pm 0.5\%$ . Other factors as demand and supply of a foreign currency on the interbank market, the intentions of the monetary politics, and the volume traded played also a role. The trading between the Central bank and any commercial bank was (and is) without commissions and also without spread. This is, however, not true for trading among commercial banks where the market prices are used and the volume is not limited.

During the year, two basic trends were reported. During the first half, the trading was increasing among commercial banks and decreasing between commercial banks and the Central bank. The intervention of the Central bank during this period was minimal, and consisted only of purchasing hard currency from commercial banks. This development was a result of the positive development of the balance of payments, the partial development of new operations as the forward market, and the consequent introduction of swap rates.

During the second half of the year the trading among commercial banks and between the Central and commercial banks increased. This was a consequence of the expectation of the split, as well as the new tax system based on the VAT. Thus, there was an increase in imports and consequently an increased demand for foreign currency on the interbank market. Major role played also the new trading system of the Central bank with the commercial banks, in accordance to which commercial banks were purchasing foreign currencies at a fixed rate. As a consequence, already during October there was an increased demand for foreign currencies, and the international reserves of the Central bank decreased.

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1. HN 4.27.1993

The foreign currency demand of the population was limited by the Kc 7500 that could be during the year exchanged. The whole amount is, however, used only partially for foreign trips, and a considerable portion of it is deposited domestically in foreign currency accounts. The overall foreign currency deposits of the population are also increased by the increasing income from the tourist industry, and from employment abroad.

The financial market in 1992 failed to respond to the economic and monetary successes. From today's viewpoint, whereas the capital market is functioning properly, and developing constantly despite the liquidity problems, the same is not true for the banking sector. The four large banks which survived from the past, have still the monopoly and can therefore dictate conditions on the interbank market.

### **THE BANKING SECTOR IN 1992.**

On February 1, 1992 a law about the Central and the commercial banks was established. In accordance to this law, the Central bank is assigned the role of controller of the banking sector and has the required legislative powers in accordance to the worldwide accepted standards. Therefore, from that date, the Central bank has an independent section composed from three branches which role is the banking sector control. Towards the end of 1991, 39 licences were issued for the operation of new banks. In 1992, 22 more were issued. From this number, (till 12.31.1992) four were state owned (one Czech - the Consolidation bank and three Slovak), 33 were stockholding companies solely owned by domestic investors, 11 stockholding companies with foreign participation, 8 stockholding companies only with foreign participation and 5 subsidiaries of foreign banks.

### **ANALYSIS OF THE ECONOMIC TRANSFORMATION DURING 1992:**

Overall 1992 could be characterized as a positive year. The Federation overcame the difficulties of the split without any major damages, except that of the delay in the transformation process. The figures for the year showed promise, but future predictions could not be made as several major problems remained to be resolved. One problem was the export composition which favored low added value products at the expense of machinery. Another problem was the concentration of foreign investment on commodity products, rather

than on production which could use more developed technology.

As the country continued to need advanced technology in order to proceed with its transformation process, the technology can be obtained through either imports or foreign investment. Nevertheless technology imports were delayed by the privatization of the large enterprises, which was not completed until 1994. Companies under the old management were reluctant to make any significant changes in their organization and production. However, once the new owners are fully in control of their companies, changes will take place and imports of technology will increase.

Another mean of obtaining technology is through foreign direct investment. Foreign companies were, however, much more eager to invest in the production of consumer goods, and generally in commodity products. Their strategy, even though correct and profitable in the short terms (since it enables one to take advantage of the low production costs) does not promise any special long term advantages. As has been shown, it is almost certain that production costs will at some point reach or approach those of other European nations. This is especially true since the country seeks to become a member of the European Community. Such a development will also mean that the country can base its exports on higher value added products, and compete through better technology and quality rather than low price. As the country seems to have all the potential for development and restructured companies are becoming more and more competitive, this is not an unlikely development. The consequences for a foreign investor who would acquire a production facility at a later date would than be not only the higher production costs, but also higher amounts of capital required for an acquisition. Therefore, a pro-active rather than a reactive strategy should be taken, whereby an investor incurs lower acquisition and higher technology, investment, and restructuralization costs now, for higher revenues later. In order for this to be understood however, an investor has to know the economic parameters of the Czech Republic and especially the forces that influence them from the beginning of the transformation process.

In the long run, companies start to realize that the low production cost is not the primary attribute that the Czech Republic (and the central Europe in general) has to offer. Therefore, in our case, attributes such as engineering skills, the existing infrastructure and the relative difficulties of industry transformation should

take precedence over low production costs. In connection with all the other economic factors, these should be used when evaluating a potential investment with long term perspectives.

As discussed previously, the Czech Republic's industrial structure is different from that of other post-communist countries. Due to its history, the industrial sector is largely composed of companies which can be restructured with less difficulties than for example, the huge conglomerates of the former East Germany. In addition, from the viewpoint of the employees and the general public, restructuring is more acceptable in the Czech companies than in other companies in the EC. There are two explanations for this acceptance. One is that the Czech industry survived the Second World War untouched in comparison to German industries. We should not forget that the German -west and east- industry were completely rebuild after the Second World War, and were therefore based on the principles of mass production. In contrast, the Czech Republic's industry consisted predominantly of a large number of medium and small plants, developed around their mid-war predecessors. During the past 40 years, these were only consolidated to large holding companies for political reasons. On the other hand, in East Germany or Slovakia which had their industries developed after the Second World War, large and inflexible plants were constructed to handle mass production processes. From the Czech employee point of view, the changes a company has to go through are necessary, and will therefore meet less opposition than by other employees in Europe. Even though this statement seems bold, it can be supported by the character of the Czech nation as opposed to the other, more "militant" nations of central Europe. In addition, one of the few positive contributions the previous regime accomplished was the educational system, which developed a large engineering force and a skilled labor force.

All of these parameters make an investment in engineering intensive sector not only possible but also profitable. Profitable not only in the long term, but also in the short term. An early investment can take advantage of the lower production costs, and in connection with the other attributes the country has to offer, an investment can secure not only an initial market share in eastern Europe, but also a penetration to the EC countries. This had already happened in the case of construction materials and other low added value products. During 1993 it started happening in the case of some higher value added products such as machinery and transportation equipment. These

developments will become more frequent once companies are restructured and start producing more competitive goods.

The next chapter presents further developments during 1993 so that a comparison between the two years can be made. Also presented will be important developments which influenced the transformation process, and which even though started in 1992 or 1993 will affect investment decisions for many years to come. Whereas the first part is more an assessment of the situation in the country, the second part will indicate the opportunities which exist for more technology intensive investment and production and, in particular, the short and long term benefits for construction companies.



## Part 2:

### 1. THE TEMPORAL SLOW DOWN OF THE ECONOMY IN 1993:

#### ECONOMIC ENVIRONMENT:

The transition to a functioning market economy has not been without difficulties. As mentioned, in 1992 the economy declined by nearly 7%. However, the Czech economy is expected to show a modest recovery in 1993 of real growth between 0.5% and 1% (Table 14). As predicted by JP Morgan<sup>1</sup>, the real GDP contracted by about 2% at the beginning of 1993 against the same period in 1992, undoing some of the 4% year-on-year gain driven by higher real incomes in the final quarter of 1992. The setback stems from inter-republic trade disruptions and perhaps from the application of the bankruptcy law in April (even though it has become obvious that the bankruptcy law will do less harm than expected). Similarly to the bankruptcy law, the attempt of the government to hold a line on real wages should not influence the domestic demand as forecasted, primarily because of the difficulties associated with its implementation. It seems therefore, that the only impact on the real GDP could have a continuous monetary tightening from the last quarter of the previous year, and the productivity of the industrial sector, which still does not follow a continuous upward trend.

The economic indicators, however, had been showing a continuous improvement from the beginning of the year. Even though the industrial production decreased during the first quarter of 1993 (-2.1%)<sup>2</sup>, and the GDP declined by 2.4%<sup>5</sup>, this proved to be only a temporary behavior. Nevertheless, production still has not resumed a continuous upward direction. This can be associated with the uncompleted privatization process and the restructuralization of companies. Overall, however, there has been an increase in construction, retail sales, and exports throughout the year.

Whereas during 1992 the trade deficit increased by \$1128.2 mil., for the first quarter of 1993 the trade deficit was only \$10.3 mil.<sup>3</sup> However, the situation

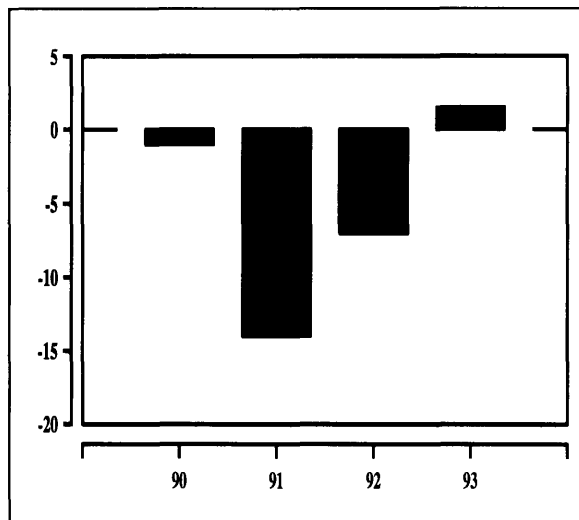


TABLE 14. Real GDP growth (% oya); JP Morgan 23.4. 93.

might be worsened by import growth, driven by capital goods demand from the newly privatized enterprises, while export gains may level off due to sluggish demand from the EC.

As far as the government budget is concerned, some government officials support a controlled budget deficit created by lower taxation of companies. They support, that by following this policy, the government budget revenues may decrease temporarily, but in the long term there will be more investment, and therefore more companies which will be paying taxes. Despite of those proposals, however, the revenues of the government at the end of the third quarter were Kc 232 bil. and the expenses Kc 229 bil.<sup>3</sup> In addition in the budget for 1994, a decrease is proposed in the taxation of legal entities from the current 45% to 42%.

The division of federal assets left the Czech Republic with \$3.2 bil. in foreign exchange reserves of which \$0.7 bil. were held by the Central bank. After a low point in January before the currency split (\$0.4 bil.), reserves are building back up again, being estimated at the end of the third quarter at \$5 bil. with \$2.6 bil. held by the Central bank.<sup>4</sup>

The population is again (after the last quarter of 1992) showing a increased tendency to savings, which has as a consequence an increase in banking deposits. This comes as a consequence of the positive economic developments. Especially savings in local currency increased by about 10% in 1993.<sup>5</sup> There is also a

1. JP Morgan, Economic Research 3.15.1993

2. EIU Country Report 3rd quarter 1993.

3. HN 6.15.1993

4. Kauppalehti (Finish business newspaper)11.22.1993

proposal to decrease slightly income taxes and to increase some government allowances in 1994. In addition, in November 1993, the government decided to increase the limit of foreign exchange each citizen may obtain yearly from Kc 7500 to Kc 12000.

From the part of the EC is expected a cancelation of all import tariffs on chemical products and automobiles, and a decrease by 40% of tariffs on goods as steel and textiles. In addition, by the end of 1994, the import quotas from central and eastern Europe should increase from 20% to 25%. If implemented, these measures should ease the difficulties created by the protectionist measures of the EC countries during 1992.

Even though JP Morgan estimated the inflation during 1993 to reach 15.5%, the government estimates the number between 16% and 18%, perhaps as high as 20%.<sup>1</sup> High inflation is, nevertheless caused by the one time 8.5% boost to retail prices attending large household purchases in December 1992, and the introduction of the VAT system. However, monthly inflation rates have consistently dropped since the January leap, and are now again well below 1%. It is predicted, however, that starting August 1993 the inflation for the next 10-12 months should be a single digit of 6%-8% (the number for the month of July was 0.4%).<sup>2</sup>

## ANALYSIS OF THE MONETARY POLICY:

After abolishing in 1992 the interest rates ceilings on deposits and loans, in 1993 the Czech National bank used a set of direct and indirect instruments to effect the monetary policy. These include credit limits, reserve requirements on time and demand deposits (lowered in June to 3% and 9% respectively), T-bills, and refinancing loans. In particular as far as the credit limits are concerned, there are three criteria by which each bank is evaluated:<sup>3</sup>

1. Solvency (starting 1995 all banks will have to subtract from their capitalization all the investments to non-bank subjects).

2. Liquidity (may be sufficient, however, banks do not have the necessary technology to built information systems that would enable the monitoring of all transactions).
3. Concentration of loans on a single customer (restricted to 25% of a bank's assets).

There has been a major dispute between the Central bank and the commercial banks over the interest rates which had been about 7%-8% higher than the discount rate. In August, the discount rate was lowered from 9.5% to 8%, and the Lombard rate from 14% to 12.5%. In accordance to the vice-governor of the National bank, this was due to the relatively low inflation predicted for the next ten months (6%-8%), the unexpected trade balance surplus at the end of the second quarter (\$300 mil.), and an increase in foreign currency reserves of \$1.3 bil.<sup>1</sup> (Kc 578 bil. in January and Kc 615 bil. in April). Thus, whereas during the first quarter the monetary restriction was necessary due to the Federation split, VAT, and due to the unexpectedly high surplus of the government budget (Kc 10 bil.), at the end of the second quarter the relatively stable economic situation enabled a less strict monetary policy. Even though the required currency reserves for commercial banks were lowered (which meant about Kc 10 bil. more cash in the economy), and the discount rate decreased by 1.5%, the commercial bank failed to response retaining their landing rates as high as 8% above the discount rate (the Central bank regards 4%-5% as the absolute high).

Lower official interest rates have thus failed to stimulate the economy, mainly because landing rates remained high and positive in real terms. This shows the poor state of the banks' portfolios, and their inability to make their operations more effective. This problem should be resolved, however, with the privatization of the banking system. Table 15 shows the lending rate, and the three month T-bill deflated by PPI and CPI.

The incorrect argument of the commercial banks is, that since there is a higher demand than supply, it is possible to charge high interest on loans. Again, there can be seen the misunderstanding of the western economic system. Even in the developed market economies where the demand exceeds the offer twice, or four times, instead of just 20%, a respective interest rate can not be justified, because it would have to be unbelievably high. Another parameter which contributes to this problem, is the non market behavior of bank employees and the insufficient control mechanisms. The decision process which leads to a

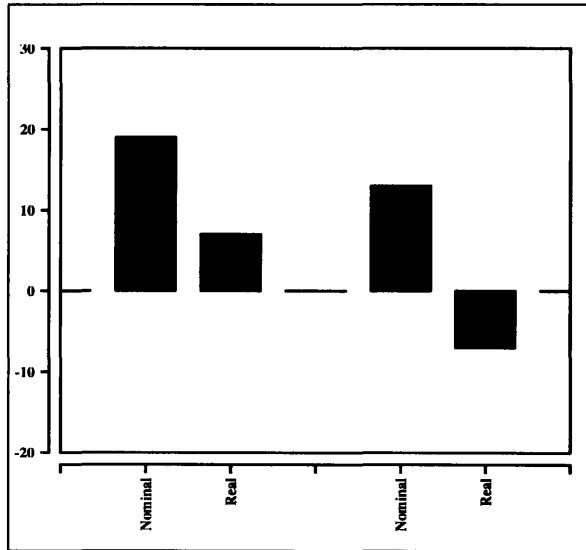
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5. EKONOM 39/1993

1. CzechInvest, 7.30.1993

2. HN 6.15.1993

3. HN 5.13.1993



**TABLE 15. The lending rate (% p.a.), and the three months T-bill rate in 1993 (JP Morgan 23.4.93).**

credit provision is exactly reverse. First parameter is the spread which a loan can provide, second the collateral guarantees, and only last the relative risk of a project.

It is expected therefore, that under the threat of interest rate ceiling imposition, the large five commercial banks will start lowering their spread (as already happens), and the amount of loans will increase. During the first four months of 1993 the amount of loans increased by more than Kc 30 bil. (from Kc 578 bil. to Kc 615 bil.).<sup>1</sup> It has to be added, however, that banks have to be selective in the loans they provide, and loans have to be provided solely on basis of economic performance.

In March 1992 the Central bank set in function a clearing system (UNISYS and its subcontractor OMNICON) for interbank transactions. Even though the system is capable to settle differences between banks within seconds, the lack of on line connection between commercial banks and the Central bank delays the whole process up to three days.

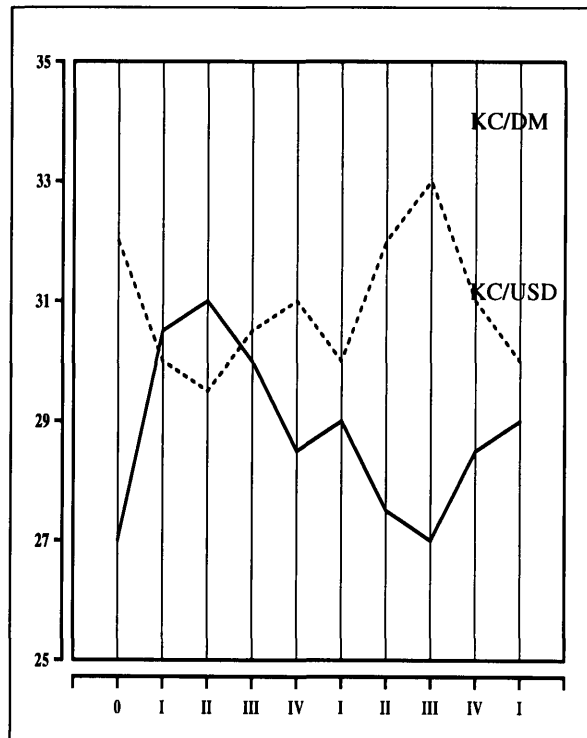
## CURRENCY CONSIDERATIONS:

The Czech currency (Koruna) has strengthened approximately 20% again all "hard" currencies over the past three years, in spite of an 11.5% rate of inflation in 1992.<sup>2</sup> The Czech currency which had been

1. HN 4.19.1993

2. Investment Report, Andrew McCabe 6.1993, Prague

pegged to the same currency basket as the Czechoslovak currency (USD 49%, DM 36%, Austrian Shilling 8%, Swiss Franc 4% and the French Franc 3%) is expected to retain its stability. Therefore, and due to the same fluctuation of the other currencies with the DM, a decision was made by the Central bank to simplify the basket (starting May 3, 1993) only to the USD 35%, and DM 65%.<sup>3</sup> Otherwise, there are not any reasons to adjust the currency's value. In real effective terms, the currency appears undervalued, retaining some competitive advantage from its drastic devaluation in 1990. Even a further 10% real appreciation of the currency, should allow Czech exports to grow by about 4% in real terms. The nominal and real exchange rates are shown in Table 16, and Table 17.



**TABLE 16. Nominal exchange rate (USD, DM) (JP Morgan, March 15 1993).**

## DEVELOPMENTS IN THE MAIN SECTORS OF THE NATIONAL ECONOMY:

Czech Republic is a country where 66% of the national income and 36% of employment come from the industrial sector. The five largest industries by share

3. HN 4.2.1993



**TABLE 17. Real exchange rate; 1989=100 (JP Morgan March 15 1993).**

of total industrial production were engineering 22%, food 13.9%, chemicals 11.9%, electro-technical and metal working 10.4%, and steel 9.5%.<sup>1</sup> However, during the few past years construction, and especially the traditionally undeveloped service industry showed a considerable growth. Thus, the real GDP stopped declining, and showed a modest recovery during 1993. This was predominantly due to the service industry, which is the fastest growing sector of the economy. In the first 9 months of 1993, the receipts from tourism were more than \$1 billion, which represents a 36% increase in comparison with the same period of 1992.<sup>2</sup>

Except for the service industry, another potential sector where further growth is expected is the construction industry. Construction industry is responsible for 11% of GDP and for 8% of employment of the Czech Republic. As showed a research of the Czech Statistic Bureau (CSU), during April it started recovering from the decline showed at the beginning of the year (for companies up to 100 workers the construction production declined in January by 20% and the volume of construction works by 26.6%, in comparison with the same period the year before). Thus, in April 1993, the volume of construction works increased by 2.5% in comparison

with the same period a year ago, whereas the productivity in current prices increased by 5.5%. The average wage increased by 28.3% for the same period from January still April in comparison with a year ago.<sup>3</sup> The statistical figures should, however, be looked upon cautiously, since there has been much debate about their accuracy, given the political developments of that time. It is being expected that after the initial revival wave construction showed in 1992 due to reconstruction works on privatized objects, there is a second wave expected in 1994. This will be spurred by the need to reconstruct old, and built new industrial complexes. Other important areas are the infrastructure (where major highways are expected to be constructed by domestic and international companies connecting the Czech Republic with the EC) and energy (due to the environmental problems with the aging brown coal power stations). Environmental cleanup projects also exist, but due to the limited resources this sector can not be considered as prosperous in comparison with infrastructure.

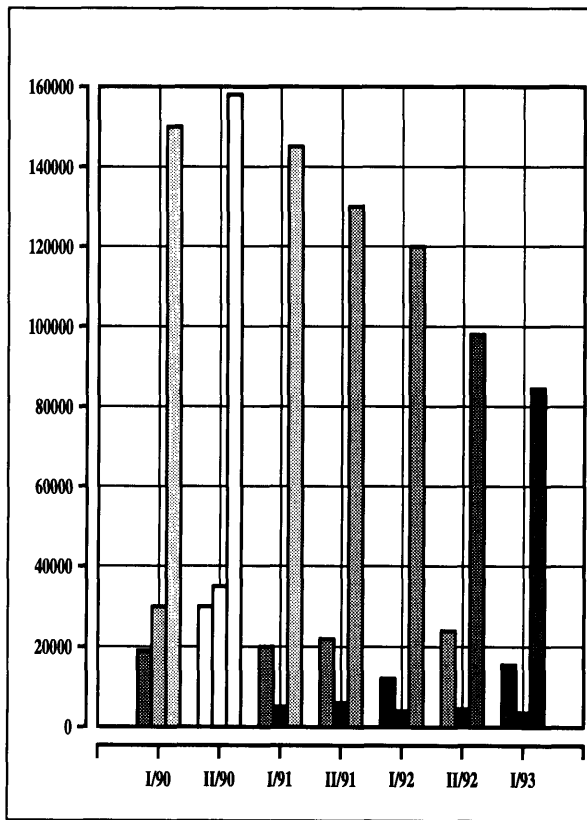
Even though the private sector in 1993 contributed by 30% (as of end 1992) to the productivity in construction (second after the 65% of the retail sector), this proportion has not been high enough to alleviate the decrease in the construction activity of the state owned companies. Thus, during 1991 and 1992 a large decrease in housing construction was realized, mainly as a result of limited financing for the large housing projects, provided by the government. Therefore, housing construction as a portion of overall investment decreased from 11.6% in 1991 to 7% in 1992 (the mean for 1986-90 was 12.5%). The number of finished apartments had been continuously decreasing and reached in comparison to the period 1986-90 21%. It is estimated that the number of finished apartments is the minimum required in order to sufficiently reproduce the housing fund, given the increase in population, the life of a building, and the increase in living conditions. Comparing the same two periods, the number for apartments started is lower by 83% which is deep below the minimum limit. Comparing the two numbers, the inventory of under construction apartments, decreased by almost 40%.<sup>4</sup>

During the first half of 1993, the number of finished apartments increased by 37% in comparison to the same period in 1992. An increase has been reported

1. US Embassy report, 6.10.1992, Prague  
2. CAROLINA, (computer journal) 11.26.1993

3. HN 6.10.1993  
4. HN 8.17.1993

from all forms of apartment construction, especially from the sector of private housing, which is influenced by the higher numbers of started apartments in 1989-90. Even though the number of started apartments during the first half is 8.9% higher than the year before, the year 1993 is the third year in a row where the number of newly started apartments is deep below the future needs. In accordance to the numbers for the first half of the year, it can be estimated that for 1993 there will be 3000-3500 apartments finished, 8 000-10 000 apartments started and 73 000-76 000 apartments under construction (more than two thirds account for private houses) in the Czech Republic. The comparison of started, completed and under construction apartments for the Czech Republic is shown in Table 18



**TABLE 18. The development of Apartment construction in the Czech Republic during the 1990-93 period (HN 8.17.1993).**

Specialists regard the above numbers as alarming and estimate that during 1994 and 1995 the shortage in apartments available will increase, bringing a shortage in the already constrained market for office spaces mainly in the capital of the country. The reasons, however, for the decreasing offer do not stem only from the lack of spaces, but also from the continuously

delayed decisions of the government concerning the housing sector legislation.

Therefore, there is an opportunity not only in infrastructure and energy which provide more short term benefits, but also in housing which has always been suffering from excess demand. The remaining problem is, however, that incomes have not reached the required levels, which would promise a reasonable payback period and rate of return. As real wages are increasing, and the lack of apartments is becoming more severe, the future opportunity in the housing sector exist. This can be seen especially in the former East Germany, where fast increase in real wages made it possible for construction companies to enter the housing market sooner than expected.

The industrial sector is responsible for about 60% of the GDP. In accordance to CSU, in the industrial sector the reported decline during January was 3.6%. Nevertheless, the decrease is said to be due to 7.6% decline in the work force, and less working days than a year before (for the same period). Accounted for the two parameters, the productivity increased by 3.2%. The wages in this sector increased by 20%.

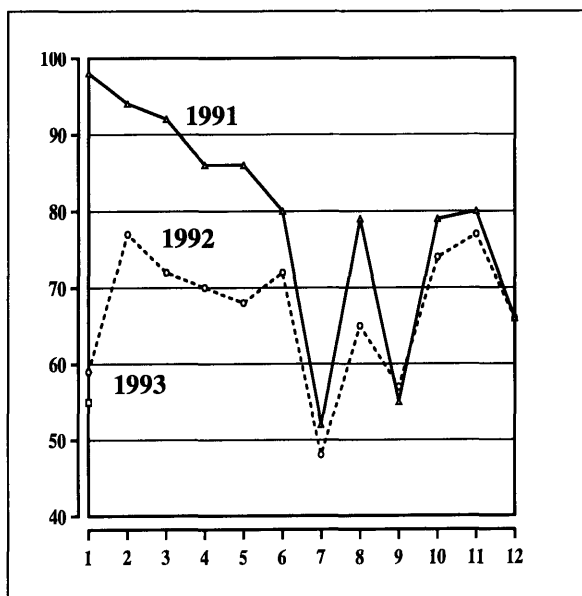
As far as transportation is concerned, the productivity decreased by 37.2%, something that is primarily attributed to the decrease of trade with Slovakia.

In the retail sector the sales in current prices increased during January by 15.1% in comparison with the year before, but the volume of goods sold decreased by 3.7% (a predictable development after the last quarter of the previous year). It has to be stressed again, however, that these figures are probably more favorable than estimated initially.

The productivity is of a special interest to a foreign investor. Many investors point out, that even though there are lower production costs in the Czech Republic, the productivity is low, and the cost advantages therefore, largely decreased. Even though its decrease has been decreasing (Table 19), and stopped during 1993, the productivity is still below comparable European standards. As in other cases, this could be attributed to the transformation process. For example, most of the production still comes from large companies where productivity is difficult to monitor and improve. Production decreased in 1993 in 58% of the large companies (more than 500 employees).<sup>1</sup>In

1. EKONOM 42/1993

addition, production processes do not meet today's requirements and hamper operations. However, leaving aside the impact of production processes and company size, as far as the work force is concerned, the productivity in the Czech Republic has always been above that of other east European nations.



**TABLE 19. The development of industrial production (1990=100%); HN 3.25.1993**

### EXPECTED DEVELOPMENTS:

Even though the situation as presented in the previous chapter did not seem too positive, nevertheless, in the industrial sector, more than 60% of companies considered the situation during the first quarter as "normal", given the period of the year (CSU report<sup>1</sup>). As well as the government sector and the foreign investors, 54% of companies asked, predict a stabilization in the future economic situation and 40% expect an increase in their productivity (with 35% of companies expecting their productivity unchanged).

What is interesting is that about 34% of companies did not face any liquidity problems and 93% of them had receivables in Slovakia (about Kc 13.23 bil.) of which 17% were considered as bad debts. On the other hand, more than 95% of companies have receivables in Slovakia estimated at Kc 6.2 bil. This shows, that the financial problems many companies face, is not caused primarily because of their products (the lack of sufficient quality for western markets), but rather due

to the general market conditions,<sup>2</sup> created by the transformation process. In addition, what can look as a negative economic development to an outsider, is "normal" to domestic companies, which have much more information and knowledge about the market.

In the construction industry, about half of the companies expect an increase in their production, but only about one third expect an improvement of their economic situation. An interesting point is that 48% of the companies asked, prepare to decrease their work force whereas about a quarter of them (predominantly the private ones) are planning to increase the number of employees.<sup>3</sup> The above numbers for industry and construction reflect the unfinished privatization process, where, the overall numbers come both from privatized and state owned companies. As a consequence, the results are distorted since the not privatized, or not restructured companies are responsible for the largest part of the employment, as well as the volume produced.

From the research conducted by the CSU, the responses of the companies to the expected development in the industry and construction during the second quarter of 1993 are shown in Table 20. It is perhaps more useful for a foreign investor to give more attention to such "domestic" information rather than to reports of overall economic performance, which are often (especially in our case) distorted.

	-	0	+	ave.
Economic situation	19.1	59.7	21.2	2.1
Production	36.1	26.0	37.9	1.8
No. of employees	63.5	30.5	6.0	57.5
Prices	11.4	46.1	42.5	31.3

**TABLE 20. Expected developments in the industrial sector in % (HN 5.18.93).**

In accordance to the Finance ministry, the most dynamic growth is reported from the small and medium enterprises. However, the small unemployment (the smallest in Europe) is creating problems in the wage politics of the government, and is responsible for the lack of qualified employees. The wage problem was created by large numbers of qualified personnel going to work abroad, as well as by foreign subsidiaries paying higher wages. As a result, Czech companies had to raise wages irrespectively to

1. HN 5.18.93

2. HN 3.25.1993

3. EKONOM 14/1992

productivity, in order to keep their employees. The government expects that the pressure on competitiveness created by increased production costs will be reduced to a certain degree by bankruptcies (which should increase the labor supply), and by government sanctions to companies (still owned by the state) which increase wages beyond a certain limit.

In general, it is obvious that companies with a work force ranging from 25 up to 1000 persons show much better results than other larger companies. They expect an improvement in their economic situation, increased exports and productivity, more investments, some of the smaller ones even an increase in their work force. The proportion of industrial production coming from the private sector grew from 15% last year to over 45% in 1993.<sup>1</sup> It is not strange therefore, that many large construction companies during the privatization process divided themselves to smaller, independent entities accordingly to the specialized divisions they were composed of. In many cases, however, this situation was necessitated not so much by the large scale of a company, but rather by the inability and unwillingness of the particular managements to adjust it to the new environment, which lacks the huge projects of the past. This development creates an opportunity for new large companies, predominantly in the infrastructure and energy markets. As there is no competition for companies who can manage, construct, and guarantee large projects, a construction company from abroad which will acquire a domestic company can easily bid on large projects throughout central and eastern Europe. In addition, with domestic engineers and foreign managers it should be able to compete in the western markets as well.

What can be seen in 1993, is the impact of the split which started influencing the economy during the last quarter of 1992. During the first quarter, decreased productivity, GDP, and foreign reserves, with increasing inflation painted a rather gloomy picture for the future of the country. In addition, problems arose with the interpretation of economic figures following the split. Nevertheless, as the reality showed later, the estimated decrease in GDP and productivity were actually lower than estimated. As in other cases where a steep decline took place, the decrease stopped quickly, and by the end of the second quarter figures resumed their upward trend. This shows, that the Czech economy even though temporarily hampered by events

not directly related to its performance is able to overcome them in relatively short time. The steep increase and drop (by approx. 40%) of inflation after subsidies were abolished in 1991, and a 80% devaluation undergone is the most vivid example. In addition, one could observe that generally the predictions of foreign institutions about the performance of the Czech Economy are too conservative, establishing their predictions on the basis of other countries' (Hungary, Poland) past performances.

## **FOREIGN DIRECT INVESTMENT:**

The Czech Republic has been successful thus far in attracting foreign investment. In 1992 \$1.1 bil. in FDI was made in Czechoslovakia; more than triple the level of 1991, 90% of which was made in the Czech Lands.

Many industrial investors have targeted specific companies. The motivation for their investment has been a desire to acquire manufacturing facilities with a skilled and low cost work force, reasonable infrastructure and telecommunications (even though with many problems), and geographical proximity to the EC. It can be expected that increasing numbers of manufacturing jobs will move away from western Europe and into the Czech Republic, to take advantage of the (up to now) lower wages and skilled work force.

During the first quarter of 1993 the FDI reached the amount of \$302 mil. (Kc 8.8 bil.), which is a 31% increase in comparison with the same period last year. According to the governor of the Central bank the FDI during this year will amount to more than \$1 bil. The largest part of the amount came from Philip Morris which acquired the former tobacco monopoly (Tabak K.Hora). During the same period a number of new joint ventures were established (Pechiney- Strojbal, Rieber&son-Vitana, etc.). Other companies were entirely purchased and transformed to local subsidiaries by large multinationals as ABB, Unilever, Ferrod, etc. Foreign investors prefer to acquire the company as a whole because it enables them to set up their own strategy, employ expatriate management and train the local staff.<sup>2</sup>

A good image has been established in joint ventures concerning the construction industry, especially in the area of cement and asbestos production. The Czech republic with its proximity to the rest of Europe, its

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1. CAROLINA (computer journal) 11.26.1993

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2. EKONOM 40/1993

knowledgable engineers, and its relatively low production cost offers excellent opportunities for companies engaged in the production of construction materials. It is not an uncommon case to see English or Scandinavian companies selling their licences or establishing their own production in the Czech Lands. Due to structural changes made by foreign investors, the importance companies put on services to their customers is also increasing.

As far as sectors are concerned, and including the tobacco industry, the first position in FDI during the first half of 1993 have consumer and tobacco products (55.3%), second is the construction industry with (11.1%), followed by trade and services (7.2%), the food industry (5.4%) and transportation equipment (4.5%). From the viewpoint of investment origin, the largest capital inflow (during the first half) was from the US (58.6%), followed by Germany (9.2%), France (6.6%) and Austria (4.7%)<sup>1</sup>.

From 1990 until the first half of 1993 the total FDI reached \$1863 mil.<sup>1</sup>

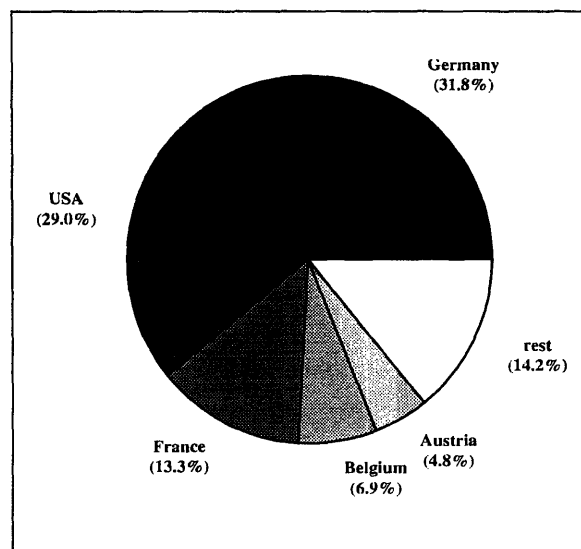
The largest investment were made to the:

- Tobacco, glass and non alcoholic beverages industry (\$504 mil.).
- Automobile and automotive components industry (\$423 mil.).
- Food industry (\$190 mil.).
- Banking (\$178 mil.).
- Chemical industry (\$111 mil.).

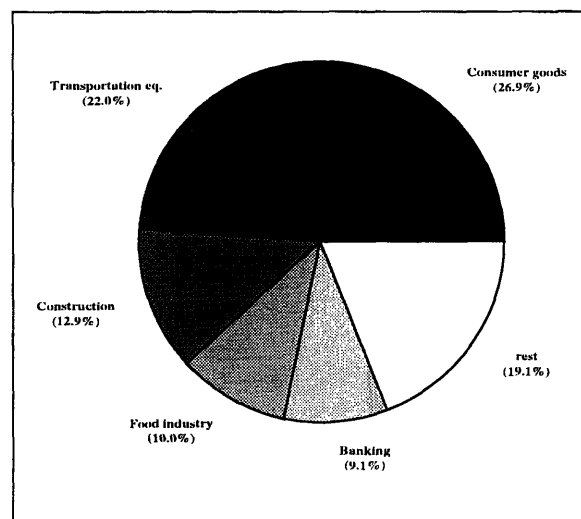
In the amount invested leads Germany followed by the US and France. Table 21 and Table 22 show the total FDI in the Czech Republic at the end of the first half of 1993.

In accordance to the governor of the Central bank, foreign investors appreciated the fact that the Republic overcame the split of the Federation in both the political and economical aspects. In addition, the continuous productivity growth which started towards the end of the first quarter of 1993, shows that companies were able to substitute at least some parts of the lost markets in Slovakia with western markets, and thus retain their revenues.

During a summit on June 15, held in Hamburg with title "Czech Republic as a business partner" the German investors agreed that the country has the best chances to overcome the difficulties of the



**TABLE 21. FDI by country of origin (EKOMOM 40/1993).**



**TABLE 22. FDI -by sector invested (EKOMOM 40/1993).**

transformation process and become an equal business partner with the economies of the EC. They pointed out, however, the known problems with infrastructure, high taxation on both domestic and foreign companies (42% currently), bureaucracy connected with the privatization process and mainly the inelasticity of the banking system.<sup>2</sup>

It has to be added, however, that large part of the FDI targets not the production of new technologies which can support exports in the long terms, but mostly production of rather commercial goods (consumer goods, tobacco, etc.). In addition, even though the

1. HN 5.13.1993

2. HN 6.16.1993



semiofficial agency CzechInvest is committed to secure for the Czech Republic foreign investments of \$10 bil. for the next five years, this amount accounts for \$667 per one employee in production or services.<sup>1</sup> The number for other OECD countries is \$6000 per employee. Nevertheless, as can be seen, the chances of the construction industry in the country as far as the infrastructure development are large, especially if the EC will implement through the European bank its plans to participate in the financing of some development projects concerning highway networks, environmental projects, energy (already under way) and telecommunications.

### THE NATIONAL DEBT:

The economic situation in 1993 has improved the credit rating of the country on the World markets. Thus, citing declining uncertainty about the creditworthiness of the Czech Republic, Moody's Investors Service upgraded the rating for sovereign debt to Baa3 from Ba1 in March 1993.<sup>2</sup> The announcement coincided with a \$300 mil. Eurobond issue from the Central bank, increased due to strong investor demand to \$375 mil., and with an interest 2.5% higher than US government bonds.<sup>3</sup> It was ironic, however, that the Eurobond was necessitated by a run on hard currency earlier in the year. In January and February, reserves held by the Central bank fell to only \$430 mil. (with total hard currency held within the banking sector falling \$200 mil. to just over \$3 bil.) leading it to seek not only the Eurobond, but also to put together a \$200 mil. standby loan through JP Morgan and to arrange a further \$240 mil. standby from the IMF to support the internal convertibility of the Crown at the time of separation.<sup>4</sup>

The borrowings as the ones at the beginning of 1993 are rare. The country's gross foreign debt is only \$7.9 bil., well below Hungary's \$22 bil., even though the population is about the same size.<sup>4</sup> Thus, whereas the debt to export ratio was 110% in 1989, and 58% in 1992, after the split and the agreement to divide the former external debt, this ratio will likely fall under 50% in 1993. The 1991 and 1992 figures are given in the Table 23.

	1991	1992	1993
Total external debt, \$billions	6.7	6.2	7.9
Short term	2.1	1.7	1.9
Owned to commercial banks	2.3	2.0	2.1
% of GDP	27	24	22
% of exports	78	58	45
Debt service ratio	15	12	10

**TABLE 23. External debt in \$billions (JP Morgan 3.15.1993).**

Even on the domestic front, the national debt is low. Because the government has not yet experienced a significant budget deficit there are few Treasury bills, or bonds on the market. Those issued are considered to have not so much a fund raising character to cover past deficit, but rather they are viewed as an attempt to "get the market moving". The ministry of finance prepared in May of 1993, to sell government bonds of Kc 16,802 bil. in order to cover the Czech Republic's deficit of Kc 1,697 bil. in 1992, the Federation's deficit of Kc 4,667 bil. for the same year, and Kc 10,438 bil. which represent two thirds of the liabilities of the former Czechoslovak Trade Bank (a bank that represented the former Czechoslovak state in the international markets). All the bonds are payable in three years.<sup>5</sup>

It is interesting that after the addition of two thirds of the Federation's debt to the debt of the Czech Republic, its debt increased from Kc 15 bil. to Kc 163 bil. This is about 17% of the GDP and about 48% of exports in 1993.<sup>6</sup> Out of the Kc 163 bil. the government's domestic debt is Kc 88 bil. Accordingly to the ministry of finance this ratio is acceptable if compared to similar numbers of developed European nations.

There has been two issues of government bonds in 1993. The first one took place in March, and was only for domestic investors. Bonds were issued at a slight discount and the yield-to-maturity was 14.6%. However, in the face of uncertainty over long term rates, and with one-year interbank rates running at around 15% commercial bank showed little interest. In June a second issue of government bonds took place, but this time foreign nationals were allowed to purchase the bonds. They were again at 14% yield-to-maturity and payable in three years. even this time the

1. HN 4.14.1993

2. EIU Country Report 3rd quarter 1993

3. FFO April 1993, The EIU

4. EBRD Report by Michael Rothschild, 1993

5. HN 5.13.1993

6. EKONOM 40/1993

interest of domestic investors was very limited.<sup>1</sup> A third issuance of government bonds is to be made during the 1994 year.

In August 1993, the Central bank made its first appearance in the Japanese Samurai market. It issued a JPY 30 bil. bond which was increased to 35 bil. due to an increased demand. The bonds are payable in 7 years, with a coupon of 6.6%. In addition, they were sold at a 100.5% premium which corresponds with the price of US government bonds increased by 169.9 basis points.<sup>2</sup> What is interesting, and what the Japanese investors new, is that the issue was not necessitated by a run on hard currency. Its aim was rather to test, and show the qualities of the Czech economy against the other economies under transformation.

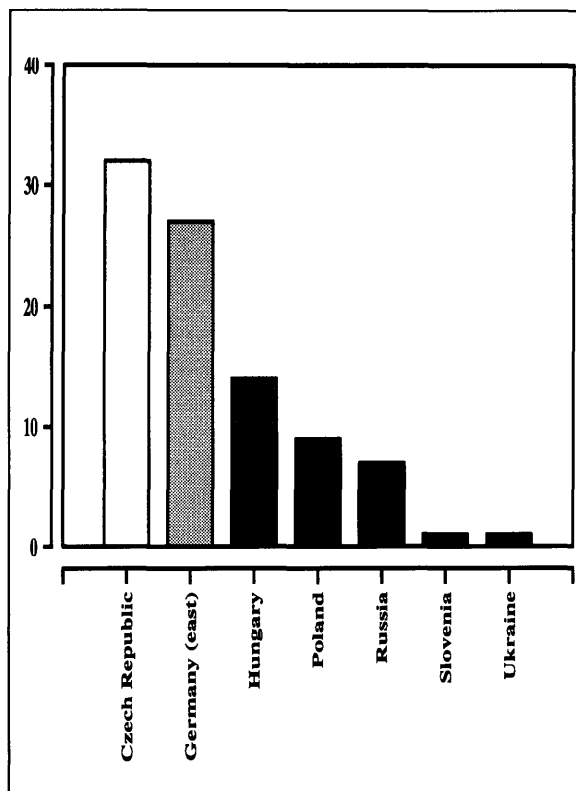
## 2. CURRENT CHARACTERISTICS OF THE CZECH INDUSTRY:

### THE OUTSIDE IMAGE:

It might be encouraging to show positive economic developments for a particular country. Those, however, are not the only parameters which influence investment decisions. What is therefore the outside image of the Czech Republic? What investors themselves say about the investing climate of the country? During a recent symposium organized by the Handelsblatt and the Wall Street Journal, in Berlin, the largest confidence was given to the former East Germany and the Czech Republic.

Up to 1992, the largest confidence was given to the former East Germany where during the past 18 months 52.3% of the participating in the meeting managers made their investments (the respective number for Poland is 29.2%, Hungary 26.2% and Czech Republic 23.1%). The image changed, however, when the participants were asked about the long term prospects of each country. Thus, as shown in Table 24, accordingly to the opinions expressed, within 20 years the Czech republic should have the most healthy economic structure in the central and eastern Europe.

This shows (in accordance to the Wall Street Journal) that the confidence in the progressive Czech economy, surprised those who were disappointed by



**TABLE 24. Prospects of economic developments within the next 20 years (Handelsblatt 1993).**

the bureaucracy, legal traps, and ownership problems. In addition, the separation from Slovakia made more difficult the access to natural sources, and the uncertainties created by the separation made many investors to seek other investment targets. In accordance to Wall Street Journal, this could be characterized as their weakness. Germany has high labor cost, Poland is known for its political instability, Hungary as an agricultural country does not have a large engineering pole, whereas the Russian market is much too risky. Hungary may have better developed service sector and Poland better entrepreneurs, but none of these countries can compare to the Czech industrial tradition and qualified labor force and low production costs. An example was given for the tire industry where the production cost was in 1993, 80% lower than that of Germany.

During the coming 12 to 18 months, 31% of the participating managers are planning to invest in the former East Germany, 28% in the Czech Republic and 20% to Poland. Even though the Wall Street journal does not claim to have representative results, the opinion pole shows the changing climate in the west. On the other hand, almost one third of the investors were cautious about ownership, and legislative

1. HN 6.17.1993

2. LN 7.22.1993

problems which up to 1994 have still not been fully resolved. More than one quarter of the respondents are not satisfied with the economic conditions, and about the same proportion is worried with the non-market behavior of managements and employees in general. However, there is a satisfaction as far as quality of work force is concerned. About one half of the respondents is of an opinion that employees in central and eastern Europe are better motivated than their counterparts in western Europe, whereas for one quarter the situation is the same.

Nevertheless, the largest problems as far as work force is concerned are seen in the lack of commercial and marketing know-how, project management skills, and in the financial and accounting region. People are not used to act independently, not so much because they could not do so over the past, but rather because during the past an independent action was mostly seen under a different framework. Thus, it could be seen as a dangerous reaction to the established order, a mean to climb up the power structure, or a rather nice and honest, nevertheless time wasting and useless attempt to create something, never to be used.

In accordance to the Wall Street Journal, the decision making has to be often delegated from the top management and through a vertical structure, instead of following a more horizontal structure as is the case in developed markets. The first think that has to be done, is to adjust a company to the western style of work and thinking, and implement it on the overall company structure. The typical advice given is: "Be patient, doing business in the east requires more time, capital, and work with the education of the management, than it might seem at the beginning."<sup>1</sup>

The good name of the Czech Republic is also being created by the sound fiscal and monetary politics. According to a representative of the Deutsche Bank, the Czech Republic follows much more strict monetarism than most western governments. As he said: "When the currency is a bit undervalued one needs less dollars to purchase it."

As the vice president of the IFC has stated earlier this year,<sup>1</sup> the Czech Republic is an economically stable country and therefore a country appropriate for investments. IFC itself is prepared to invest in heavy industry, hotel construction and financial services. It is prepared to cooperate mainly with 100% domestically

owned companies which are seeking capital support or foreign investors. So far the IFC has invested \$17.8 mil. to a company producing construction materials (mainly cement and asbestos), \$6.5 mil. to a commercial bank (Zivnobank) and \$20.3 mil. to a machine tool company (DEZA). Its management also approved a loan to the Skoda-Volkswagen company of DM 200 mil., is considering to participate in financing of the western oil pipe from Germany (DM700-800 mil.), as well as in the construction of gas pipes and highways in the Czech Republic.<sup>2</sup> As can be seen, foreign investors are interested not only in the most prestigious sectors of the Czech economy as the automobile and food industry, but also in the infrastructure development, hotel construction and in the tourist industry. Finally, any interest in almost any sector of the economy has profound implications for the construction industry.

Despite the above facts, many foreign investors are confused when thinking about investment - says the director of the Czech Agency for Foreign Investment. They do not know how to enter into the Czech industry. Should they participate in the privatization process, negotiate with the Fund of National Property, discuss directly with the management of a company or initiate a green field investment? The privatization is an unique action and there is now doubt that the opportunities of participation in it are limited. There was a possibility to participate in a privatization project of a certain company (submitted to a ministry under which the company has been registered and subject to approval by the ministry), up to the end of 1993. Nevertheless, the simplest way would be to invest to an already privatized company. In this case the investor can acquire the shares available either through direct negotiation with the management, or through the Stock Exchange. The most effective way of investment is - in accordance to the Agency - the green field investment. Even though it may seem to be more effective only from the government point of view, there are also obvious advantages from the investors' perspective, who does not have to face unexpected problems when acquiring a stake in a company. Further discussion on privatization is provided in the third part.

German investors are tempted primarily by the low production costs. This may be seen primarily in the construction materials industry, but also in the machine industry, textile and furniture industry as well in the

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1. EBRD Report by Michael Rothschild, 1993

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2. HN 5.16.1993

production of plastic and aluminium casting forms. However, accordingly to the director of the German industrial and trade office in Prague, few of them know about the difficulties they may face.<sup>1</sup> There are not so many good companies in the country, and there is a large demand for those few companies who are. He suggests that a potential investor should only invest in a already privatized company (there will not be any state owned companies by the end of the second wave of the "Large privatization" process). Only in such company the management functions adequately, but even then there a shortage of capable managers can be observed, as few are capable to think and act in accordance to western rules.

An example can be seen in the joint venture of the German Babcock-Borsing AG and the Czech machine manufacturer CKD (state owned company). The Germans were overwhelmed by the huge production spaces, and the modern machinery available. On the other hand, the Czechs expected an access to the German market, and new orders. Problems arose, however, when the company should start functioning in accordance to the western rules. The Germans accepted the compromise to employ 100% more employees than needed, but even though the wages were lower, the productivity was about the half of what is in Germany. The German company had continuously about 15 managers travelling between Germany and the Czech Republic, and the lower production costs advantage soon started to disappear. Finally, the low productivity, the increase in the management's transportation costs, and the difficulties in understanding each others behavior led to the break up of the joint venture.

The American view seems to be more positive perhaps due to the fact that companies from the US are much more cautious (but also too slow in their decision making). Investments are made by huge multinationals, and almost always they either acquire the whole company, or at least control the major portion of its shares (it is interesting to mention that German companies investing in the construction material industry followed the same pattern). The most important aspect for an American investor is political stability, sound macroeconomic politics, and a transparent legal framework (which is still not functioning properly). As far as the tax break, which was proposed by small and medium American

investors is concerned, the opinion of the US ambassador is that even though high, taxes are not the main issue.<sup>2</sup> Investors primarily need a transparent and beneficial climate, similar to that in the rest of Europe. Besides as a country with political stability, the Czech Republic's other advantage in comparison with the other countries of central Europe is its proximity to the western markets. This makes it an advantageous production platform for American companies which want to enter the European market.

Japanese companies on the other hand do not rush to invest. The south-east Asian countries promise them much faster return of their investment than the recession hidden Europe. Many Japanese companies may have located their offices in Prague, but their mission is to collect market information, analyze its behavior, and create distribution channels and services for their products. As can be seen, the strategy followed is the same as when Japanese companies were entering the American and west European market. They created commercial and service subsidiaries, and when the sales were high enough, than they established production facilities. Thus, some Japanese multinationals have already started selling directly their products, whereas other try to penetrate the market through Czech companies, franchising them new products and processes. It is expected, however, that mainly those Japanese companies, who are suppliers of other large multinationals will show interest in Czech manufacturing companies. This behavior can be explained by their desire to approach companies they supply in Europe. Another reason is their relative inexperience in international markets which makes them to seek already established businesses as a mean to penetrate in new markets.

## **THE PRODUCTIVITY PROBLEM AND THE WAGE INCREASES:**

During the second quarter of 1993 it had become apparent to the government that wages were increasing too fast, and threatened therefore with future inflation. During the first quarter of 1993 the real wage in the industrial sector (35 or more employees) increased by 0.6% in comparison with the same period last year. For the same period, productivity was 0.9% lower. In construction the numbers were 5.4% and 9.5%, whereas on the macroeconomic level productivity

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1. HN 9.6.1993

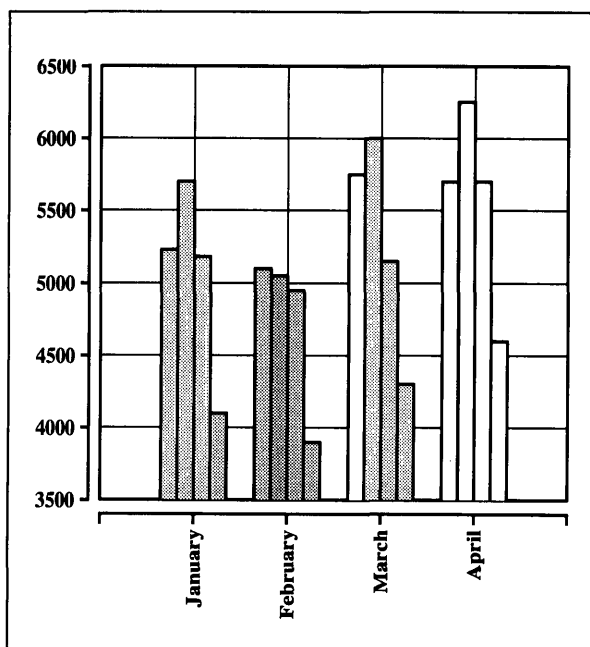
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2. EKONOM 34/1993

(measured as GDP per employee) decreased by 2-2.5%, and the average real wage correspondent to this indicator increased by about 7-7.5% (more conventionally, the real wage expressed as the comparison of the nominal wage and CPI increase increased by 5%). The developments from 1992 and during the first quarter are shown in the Table 25.

	Jan. 1993	Index, Jan. 1992 =100
<b>Industry:</b>		
No. of employees (000)	1 408	92.4
Productivity in CP and Kc	49 304	118.7
Average monthly wage (Kc)	5 229	120.3
<b>Construction:</b>		
No. of employees (000)	199	96.7
Productivity in CP and Kc	16 631	88.8
Average monthly wage (Kc)	5 663	127.2
<b>Domestic trade:</b>		
No. of employees (000)	139	89.8
Average monthly wage (Kc)	4 166	124.0
<b>Transportation:</b>		
No. of employees (000)	170	90.1
Average monthly wage (Kc)	5 198	139.1

**TABLE 25. No. of employees, productivity and average wage for companies with more than 25 employees (HN 4.14.1993).**



**TABLE 26. Average wage in the main sectors of the economy during the first quarter in 1993 (HN 1.7.1993).**

Inflation, however, was not the only reason which alarmed the discussion around the wage increases. Not

only increased wages were reported, but also decreased productivity, a combination which threatened the competitiveness of companies by lowering output and increasing prices. In the long run this development would also mean increased unemployment, since companies would have to start lay off due to lost markets. This development could not be excepted by the government, since the low wages are one of the last comparative advantages the Czech economy possessed during the early years of transformation. Despite the opposition from work unions and employers, the government prepared a law (implemented on July 1 1993) about wage regulation. As one could expect, the regulation was especially made for those companies still owned by the state, and in accordance to the ministry of finance, 99% of the companies affected would be state companies.

The regulation itself was simple. Any company which wage increase would exceed by 5% the increase in consumer prices would be affected. In particular, if a company's rate of wage increase exceeded the revenue rate of increase by 15%, no penalties had to be paid. If the number is between 15% and 30% a penalty equal to the amount of wages paid above the limit set by the revenue increase had to be paid. If the increase is beyond 30% a penalty three times the amount above the limit set by the revenue increase had to be paid.

As can be seen, the regulation had as a target to prevent increases in wages with decreasing productivity at the same time, a pattern followed mainly by the large state owned companies. The time for which the regulations will remain in place depends on developments in wages as well as on the privatization process (once the companies are private the regulation becomes meaningless). The government, thus attempts to prevent what happened in the former East Germany where the pressure of syndicates brought wage increases, unemployment, and high production costs (from the viewpoint of productivity) all of whom resulted in the problems the country is facing today.

## THE BANKRUPTCY LAW:

The bankruptcy law was initially accepted by the parliament in October 1991, allowing a company to be taken to a court only if it had accumulated an extensive debt, which could not be repaid. Already at that time, the fear of a future avalanche of bankruptcies by state owned companies, caused the law to be postponed for one year. The companies were no more under the direct

control of their funding ministries, but their ownership was transferred to the Fund of National Property, which task was to privatize them. This “twilight zone” period, during which the companies were (and some still are) awaiting privatization is characterized by a series of mismanagement by company upper management, often time whose primary goal is personal gain. This continuous abuse of state resources, and problems with domestic and foreign customers and banks, resulted in the liquidity problems most of the still not privatized companies face today.

After the first delay, the bankruptcy law was consequently postponed for six more months (until the end of 1992) and than again until April 20, 1993, with the explanation that the law has to be amended in order to account better for companies with the so called “secondary debt problem”. The secondary debt problem means that a company is unable to pay its creditors due to a liquidity problem created by overdue receivables. The inter-enterprise debt has accumulated as company managers, not having enough capital, have bypassed banks by supplying each other with goods and services that they have not paid for. The fear of the government was, therefore, that since most of the companies were participants in a perplex network of creditors and debtors, the first major company which would go bankrupt would initiate an avalanche of bankruptcies affecting the whole economy.

The amended law therefore, allows to a company which has been taken to a court, a three month period during which the creditors and the debtor are supposed to find an out-of-court procedure to settle their differences. This time period can be extended in some cases (for example if a foreign investor is interested in the company) up to six months. It is obvious, however, that the time period given is not sufficient for any company to simply repay at least the 45% of its debt as specified by the law. If creditors and the debtor will not find a common way to resolve their differences, the government may be willing to help by purchasing the company’s receivables. This would happen, however, only in case of those companies which can prove their future prosperity once released from their debts, or in the case of companies important for the national economy. Exporting companies for example, which have accumulated receivables from abroad are expected to have priority in receiving government help, since a lot of domestic suppliers are dependent on them.

Nevertheless, it is not necessary that a company is taken to a court in order to be liquidated. If a wholly state owned company is not capable of securing enough orders to continue its operations, the Ministry of Industry and Trade could decide to liquidate the company. Thus, during the past two years over 100 industrial and construction companies were liquidated before even they could submit propositions for their privatization.<sup>1</sup>

It is not only the State (or the Fund of national Property) who owns all or parts of the companies under consideration. There are also large banks which acquired companies through the Investment Funds they founded during the first wave of the voucher privatization process. They are therefore not only the owners, but also the creditors of the same, or a different company. Therefore, since the government’s help cannot always be expected, during the period given by the court, restructuralization should take place. This might be an opportunity for a foreign investor to acquire a large enough share of a company (in exchange for paying its debts) which would give him sufficient control over its operations. This argument may be supported by the fact that commercial banks which are the largest creditors, are not willing to leave their debtors go bankrupt, and will be therefore willing to accept the influx of new capital on less favorable terms. An additional chance for foreign investors is that mostly small, and mid size companies which require less investment, and are more flexible are expected to be the first to face bankruptcy, as it is difficult for them to exercise any considerable pressure on the large firms, where their receivables are. Current development show, however, that only about 5% of companies which file under protection go actually bankrupt.<sup>2</sup> This development is supported by the commercial banks willing to support their companies, and by successful mitigation processes among creditors and debtors.

## **THE SECONDARY INDEBTNESS PROBLEM AND THE RECIPROCAL WRITE-OFFS:**

The bankruptcy law was yet another step towards the market economy. Even though the government recognizes bankrupts as a legitimate tools for the

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1. HN 4.20.1993

2. EKONOM 34/1993

restructuralization of the economy, it is prepared to use other, out of court processes to achieve its aim. The purpose of those processes is not so much to minimize the burden that would be imposed on courts, but to prevent the so called “domino effect” or a chain of bankrupts and consequently a high unemployment. This approach does not mean an individual approach for each company, but a creation of a general rules applied for the whole industrial sector. On the other hand, it does not exclude the possibility of government intervention in the case of large companies which bankruptcy could initiate the “domino effect” or create regional unemployment.

The receivables of companies registered in the Czech Republic decreased during 1992 by Kc 1.5 bil. and reached Kc 370.9 bil. at the end of the year (Czech Statistical Bureau). Overdue receivables from domestic companies decreased by Kc 3.4 bil. to Kc 152.3 bil. whereas the same figure from foreign companies increased by Kc 6.9 bil. to reach Kc 36.8 bil. On the other hand, the volume of payables decreased during 1992, by Kc 61 bil. to Kc 282.2 bil. From this, the overdue amount decreased by Kc 12.8 bil. to Kc 94.4 bil.

From the above figures can be seen the liquidity problem (or the so called “secondary debt” problem), where companies as a whole have four times larger receivables than payables (370.9 versus 94.4).<sup>1</sup>

The out of court tools were proposed in such a way, that the risks associated with the resolution of the liquidity problem would be assumed by both the government and the private sector.

The basic tools the government uses, or has proposed to be used are:

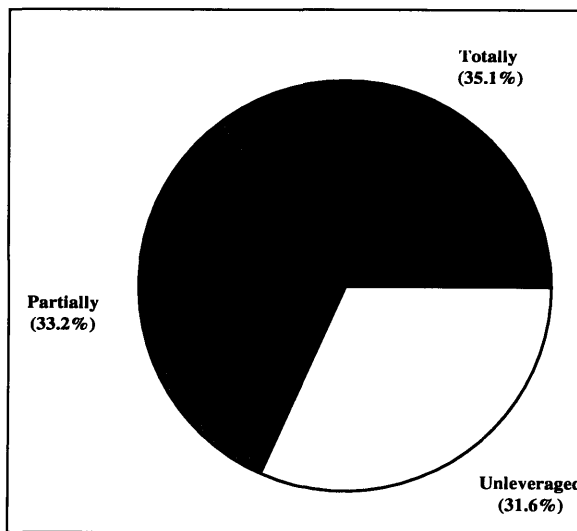
1. Reciprocal compensation of receivables and payables.
2. The purchase and trading of receivables.
3. Debt - equity swaps.
4. Bad debt write-off and their addition to expenses.

#### THE RECIPROCAL COMPENSATION:

Among many companies, complex sets of ties based on credit or debt were created. The problem was, therefore, to find those ties and write-off amounts owned among companies. In addition, if such a chain of debt and credit relations could not be closed, or if other inequalities appeared a Kc 1 bil. amount from the

Fund of National Property (represents the government) would be used. A consortium of three companies (Credit Management, Credittax and PZU) were assigned with the task to find, and account for the possible write-off. The whole operation was conducted from May 19 to June 15, 1993 and included only debts overdue. The only cost for a company was 1% of the company’s accounted receivables and payables. Finally, the participation in the whole process was not compulsory but in the case a company would later be taken to a court it would not receive the three month protective period. In addition, a company would not be permitted to use the other three means in order to prevent its bankruptcy.

In spite of the general expectations, only 3297 out of about 14 000 companies participated in the compensation process, only Kc 20.5 bil. of receivables and payables was accounted, and the overdue receivable decreased only by Kc 10.3 bil. The success was therefore only 22.3% since the expected decrease of the secondary indebtedness was Kc 50 bil. The total value of receivables reached Kc 112.4 bil., the payables were Kc 46.1 bil., and 102 697 debt or credit ties were found. From the Kc 1 bil. freed from the government in order to complete the “chains” Kc 586 bil. was used.<sup>2</sup> The success in resolving the approximately 102 000 ties is shown in Table 27.



**TABLE 27. The resolution structure of the compensation operation (HN 7.13.1993)**

Since the bankruptcy law is already active, the low participation could be explained as a confidence of the creditor companies that their credits will be returned,

1. HN 7.18.1993

2. EKONOM 42/1993

or a believe in their own economic strength which can deal with considerable loses from bad debts. It has to also added, that the Compensation method will not resolve problems of those companies that have a primary debt problem (receivables lower than payables) and therefore a second round of reciprocal compensation is planned to start early in 1994. It has to be pointed, however, that this operation has only temporary character until all the companies will be privately owned.

#### **THE PURCHASE AND TRADING OF RECEIVABLES:**

If a company finally files for a bankruptcy, is taken to a court and fails in the three or six months period to repay its debt, its assets are finally sold. However, this whole process can last from one to two years, something that could create financial problems for the creditors of the bankrupt company, and could consequently initiate the “domino effect”. The bad debt purchase and trading done by other companies or banks is therefore, expected to provide the creditor with instant cash. The creditor which is in a need of cash (almost always a company which had supplied the bankrupt debtor) can therefore sell the bad debts of the bankrupt company for a lower than the nominal price. The buyer (which will mostly by a bank or a factoring company) than expects to make a profit either by selling later the bad debt for a higher value, or by waiting until the bankruptcy process ends and the creditors are paid off. There is, however, a possibility that the market price of some receivables will fall so much, that their sale will not prevent a company from financial difficulties, due to lack of liquidity (which will arise when its payables exceed its receivables). Such a company will find itself suddenly having a primary debt problem, and will become therefore a candidate for bankruptcy. For this reason the government through the Fund of National Property freed Kc 9 bil. in order to create a reserve fund, which would finance the bad debts which price would fall below 50%-60% of their nominal value. This amount will be distributed to the Consolidation Bank (a state bank acting as a state financed “dust-bin” for non performing loans), and possibly to the consortium of the three previous mentioned companies as a low interest loan. The Consolidation bank and the consortium would then in fact purchase the bad debts above the market value, and still hope to capitalize on them later on. However, in order the creditor company to receive its credit from the Consolidation bank, it is

subject to some restrictions, as for example to have a special account at the bank and to have overdue receivables of at least Kc 100 000 from a company which assets have a certain minimum value. On the other hand, there will not be any restrictions from the part of the private companies assigned with this operation which will, however, offer lower price than the state owned Consolidation bank.

The whole system of purchase and trading of receivables is based on the assumption, that on the one hand the bad debt purchase could (or will) be done above its market value, but on the other the buyer could (or will still) be able to capitalize on it by trading it further. On the one hand, it is obvious that purchasing bad debts in market values will not solve the liquidity problem (since the prices will be too low), on the other if they are not purchased on market values, they can not be further traded (since there will not be any demand). What seems therefore certain, is that the government will have to pay for the two years during which it transferred the state companies to the Fund of National Property. During those years (the “twilight zone” period), companies were taken off the government balance sheet and left without any significant control, without being transferred to private owners.

#### **DEBT-EQUITY SWAPS:**

Even in this out-of-court settlement option of debt problems, the state is the major player. The involvement of the state is mandatory because of the unclear conditions prevailing in companies’ ownership (since the privatization process is not completed yet), and because of the liquidity (or secondary debt) problem itself.

If the state is the sole owner of a company, this method is a type of privatization. If on the other hand, the company is already partially privatized (the state owns an unsold share through the Fund of National Property) the situation is more complicated. It can be resolved by transferring stock form all the major stockholders (state and the investments funds, not individual shareholders) to the creditor. When the nominal value of a company shares (the value of the tangible assets per share in this instance) is higher than their market value, the procedure would be the same, except for that the state would assume the loss of the individual shareholders. Individual shareholders would therefore have not to pay the difference between the nominal value of their investment, and the actual market value of the shares they own.



It is interesting to mention that some foreign construction companies which has invested in the construction materials production sector, has followed the debt-equity method in order to acquire such a share of a company which would give them an overall control.

#### **BAD DEBT WRITE-OFF AND THEIR ADDITION TO EXPENSES:**

For some companies, the primary reason which led them to the secondary indebtedness position, were the bad debts incurred from their foreign trade activities since 1991. The write-offs would improve the position of some companies, but due to the high amount owned from foreign customers (Kc 36 bil.)<sup>1</sup> it would not resolve the problem entirely. The proposition is, therefore, to allow any company to write-off bad debts only if their market value would decrease below 45% (the corporate income tax up to 1993) of their nominal value and expensed them. This proposal may seem strange, since due to the high amount owned among the companies, would mean lower tax income for the government. On the other hand, the low percentage is perhaps the only the mean the government posses, to press the state companies not to prefer this easy option, and to help the most troubled companies out of their liquidity problems. In addition, the write-offs of bad debts does not create any liquidity which could be used as payables, and therefore does not resolve the fundamental problem of secondary indebtedness.

#### **EXPORTS, TRADE FINANCE AND INSURANCE:**

##### **Export guarantees and financing.**

At the end of 1993, almost two years will be completed from the establishment of the Export Insurance and Guarantee Company (EGAP). It is a joint stock company which shareholders are Czech ministries, with the ministry of finance as a guarantor of its financial liabilities. As of 1993, the company had Kc 1.5 bil. in available capital and could insure up to Kc 5.5 bil. of commercial risk. As can be seen, it is the Czech version of the German HERMES, or the French COFACE, which aim is to insure the exporting firms from short, medium and long commercial and political risks. In addition, it offers low rate export financing loans to domestic companies (the local content of the

exported goods has to be at least 60%), as well as to foreign customers. The EGAP so far operates only with capital from the government budget, but it is expected that further funds will come from the international capital markets, with government guarantees. These funds would than serve primarily as refinancing loans to commercial banks which finance exporting companies, or foreign importers. Sine, however, the funds from the international capital markets will be most probably obtained at a higher cost, and because debt is currently expensive in the Czech Republic, the refinancing loans to commercial banks, and the export loans made to companies would have to be too high. This would result in lower exports and financial problems for the exporting companies. A proposal has been made therefore, to create a fund within EGAP which would subsidy the interest difference, so that the maximum required cost of the refinancing loans would be lower than that, which export financing banks can obtain on the market. This is especially important for Czech exports, because it is estimated that an amount of Kc 20 bil. is needed in order to increase export efficiency, which is considered as inadequate (currently EGAP can cover exports up to Kc 8 bil.).<sup>2</sup>

The Czechs report several serious problems with their exports. The first is the decrease of their share in the overall World exports due to the inadequate support of pro-exporting activities; Table 28. In 1992, exports per capita accounted only for \$779 in comparison to Portugal where the number is \$1539.

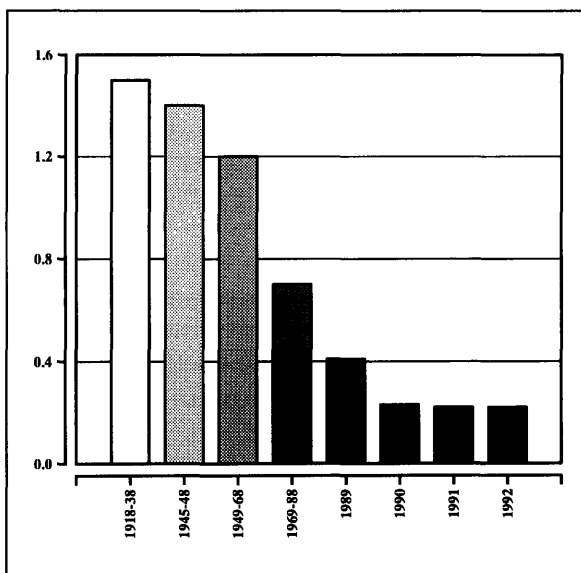
Another alarming factor is the structure of the exports still oriented towards raw materials and semifinished goods. Even though research during 1960 showed that the energy consuming and low value added production of semifinished goods and raw materials is not the proper way to increase the export efficiency of the Czech Republic, the trend is still continuing.<sup>3</sup> Due to the loss of the former East Block markets the exports of finished goods decreased dramatically. To this contributed also the more intense competition in the EC. Whereas OECD countries spend 10% of their export proceeds on energy imports, the number for the Czech Republic is 19.4%. In addition, whereas the imports during 1992 were \$340 per capita, as far as machinery, equipment and transportation means are concerned, from this amount only about \$200 went to imports of new technologies

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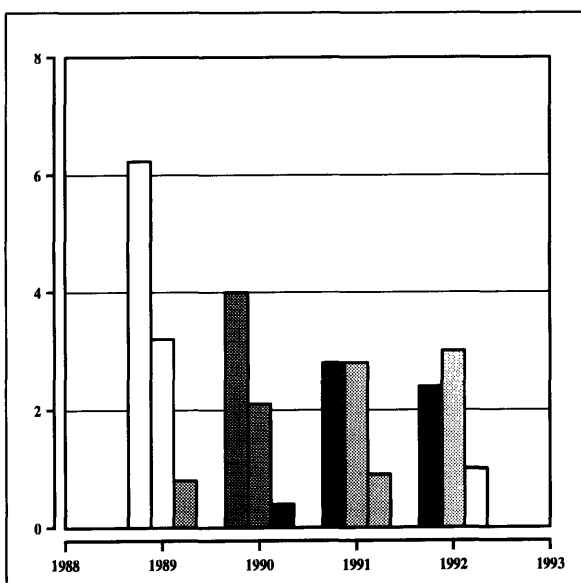
1. EKONOM 42/1993

2. HN 3.10.1993

3. EKONOM 36/1993



**TABLE 28. The share of the Czech Republic in World exports (HN 4.14.1993).**



**TABLE 29. Export structure of the Czech Republic in 1991-92 in ECU bil. (HN 4.14.1993).**

necessary for the transformation of the industrial sector. Even this amount is, however, far from adequate since other small countries invest an amount about ten times larger. Therefore, if the country wants to be able to compete with quality rather than low price, it must invest much more in imports of new technologies. As will be further analyzed, this investment can be obtained either through increased FDI, or with properly structured imports.

The export financing offered by EGAP is mostly used by foreign companies, or companies with foreign participation, rather than by their Czech counterparts.

In accordance to EGAP officials this happens not only because lot of the Czech companies do not want to commit themselves for longer periods before they are fully privatized, but also because the current management does not understand the benefits of such an option.

### CAPITAL INCENTIVES:

Especially for the small and mid size sector, there are several forms of financial assistance for companies based in the Czech Republic.

From the EC and the PHARE program (Poland and Hungary Assistance for Restructuring Economies) there is a financial help available for companies up to 100 employees, which provides loans up to Kc 4 mil. payable in five years with interest 2% above the discount rate.<sup>1</sup>

In February 1993, the Czech National Bank (the Central bank) and the European Investment Bank agreed on a loan of 57 mil. ECU to be made available. From this amount there is a help available for projects between 40 000 and 20 mil. ECU, and for those who will obtain 50% of the necessary capital from other sources. Joint ventures with EC companies are preferred. The interest rate and the repayment date will be specified individually, but the EIB will make the funds available to the Czech Central bank with a spread of only 0.15%, and the repayment period is estimated at 15 years.<sup>2</sup>

A second agreement with the Export and import Bank of Japan also in February 1993 made available an amount of 8.7 bil. JPY. Out of this amount \$20 000 to \$10 mil. can be made available for each project focused on modernization, productivity improvement or restructuralization of companies up to 500 employees. Up to 70% of a project can be financed from this loan (called also the Two Step Loan). The repayment period is also 15 years<sup>1</sup>.

The Czech-American Entrepreneurial Fund supports the small and medium sector either with a direct loan of an amount up to \$1.5 mil., or as a capital partner whose contribution is negotiable. The interest rate is the same as that of the other commercial banks, whereas in the case of a partnership, after the project had achieved the required returns the Fund makes its

1. FFO April 1993, The Economist Intelligence Unit

2. HN 5.26.1993

shares available for other investors. This fund is oriented mainly towards environmental projects.<sup>1</sup>

The 1993 Income Tax Act which established the VAT abolished many of the tax incentives provided to some joint ventures operating in certain sectors, or with large foreign shareholdings. All firms are assessed a flat tax of 45% on corporate income. As it was expected, however, the high corporate tax was lowered in 1994 to 42%.

## **DIRECT FOREIGN INVESTMENT AND IMPORTS, SUGESSTIONS FOR FOREIGN INVESTORS:**

So far we have seen that the path the Czech economy has been taking is a positive one. The difficulties are being overcome, and the investing image of the country is good. Problems with privatization, the banking sector, and liquidity remain, but they should not pose large obstacles to foreign investors, as they are connected to the privatization process, and therefore have a temporal character.

In 1992, the Czech Republic received (despite the uncertainties about the split) almost \$1 bil. in foreign investment. It is estimated that during 1993 the figure will reach \$1.5 bil. The question is: "Is this enough?" Is this amount sufficient to support the development of new technologies, and restructure from heavy to light industry, and mass production to specialized production as it was the case before the Second World War? Korea (which was not an industrialized country) needed a \$1.14 bil. of investments each year, over a 25 year period in order to build its industry. Even though the figure for the Czech Republic is similar, a large portion of that number is directed to areas which do not support the development of new technologies, but rather production of commodity goods. Assuming that the country will obtain the necessary amount of investment, the next question is from where the new investment will come? There are two primary sources, direct imports, and FDI. One could argue, that once the Second Wave of the "Large privatization" is over and companies are under new management, there will be incentives to import technology, on the basis of which the old technology can be improved, and new one developed. However, will the country be able to sustain large imports of expensive technologies without running a large trade deficit? As illustrated in this section, developments in 1993 showed the steady increase of foreign currency reserves which were

generated by increasing exports. Such a constant increase in currency reserves should be able to support more intensive imports.

What implications would increased technology imports have for foreign investors? First, they would show a commitment from foreign and domestic investors to utilize the industrial base the country offers, and to reorient it from the heavy, energy-intensive, primary industry to the light industry and engineering for which it was known. In addition, the opportunity for foreign investment would be a better choice earlier rather than later. The opportunity to acquire production facilities is there as long as companies are not fully restructured, but will become more difficult as things will become more stable. As companies secure new markets for their products and start being profitable, stock prices will increase (as already started happening in 1993). Furthermore, an increased number of companies will have already found foreign partners or will have decided to proceed on their own. Opportunities for FDI will exist for as long as the country is not fully integrated in the western economy. (Governmental predictions call for the full integration of the country with the EC year 2000.) However, even during the period until full integration opportunities for investment will be decreasing. For all these reasons, a foreign investor should follow a proactive rather than a reactive strategy when considering acquiring a stake in a business.

As discussed, in addition to imports the other method of obtaining the necessary technologies is Foreign Direct Investment. The foreign investment that CzechInvest wants to attract (\$10 bil. over five years) is the amount the country needs to invest in its industrial sector in order to restructure it. That means \$2 bil. of FDI per year. The country is, however, not receiving this amount. What are the reasons which do not allow for larger foreign investment to come (even though the Czech Republic receives the second largest, and the fastest growing foreign investment among all the former East Block countries)? And why a country with 66% of national income and 36% of employment in the industrial sector, receive only about 30% of the total FDI to that sector? Factors which discouraged foreign investment decisions are as follow:

1. the devaluation of the currency and the abolishment of the state subsidies in 1991 (It took the country a year to recover from the inflation, and created uncertainties about future developments);

2. the split of the Federation a year later (It prolonged further the uncertain period by creating disturbances in economic performance domestically and questions about the political stability internationally);
3. the unfinished privatization process (On the one hand this created many opportunities; on the other hand many risks for the predominantly risk adverse foreign corporations);
4. the non-market behavior managements awaiting privatization (Most often they were unwilling to provide financial information about their companies performance, an example of "old times" attitude when information had to be concealed);
5. problems with the banking system, the insufficient market liquidity and the secondary debt problems (All of the above were connected with the tied monetary policy and may not have a direct impact on a foreign subsidiary that can generate liquidity through exports. Nevertheless, those parameters can influence its performance indirectly through its various suppliers or through the inefficiency of the banking system itself);
6. the legal system and bureaucracy (As the new legal system had to be formed too fast, and many of its components have not been sufficiently tested, laws are often times defined vaguely. In addition, many public services connected with business and investment are staffed by the same people as in the previous regime. They either do not want to meet or do not understand the new business practices. Both these factors bring frustration and time waste, which translate consequently to decreased revenues);
7. the bad "marketing" of potential Czech companies even by institutions such as CzechInvest (Since the country is small, it should position itself as an entry to other east and west European markets, and as a pool of experienced engineers and technically skilled work force, rather than as a low production platform);
8. recession in the EC (In addition to all the domestic parameters the general economic slowdown imposed restrictive budgets on European companies).

All of the above factors has something in common. They are connected with the transformation process and should therefore be of a temporary character. Therefore, an investor who is able to transform the potentially negative factors into an advantage, or who is willing to take the risks, will eventually benefit. As

in other cases, the risks as viewed from the outside seem larger, and more discouraging. A potential investor has to bear in mind two important things. One is that each central European country has to be evaluated separately and on the basis of more than just economic performance. Mere numbers does not mean much; one has to acknowledge the forces which influenced them during the initial stages of the transformation process (in our case 1992 and 1993). The second important consideration is the fast pace at which changes are taking place. Past risks may not be present in the future or may have changed character. Nevertheless, their results will have continued effect and one has to know them in order to understand which the real conditions are. Assuming that the Czech Republic will not be fully integrated to the western markets until the year 2000, a strategy for foreign investment should examine the 1992 and 1993 years and base its decisions on developments that took place during these years. For example, had more investors examined the underlying factors of the Czechoslovak economy, they would not be discouraged by the one time influences of the past, as the sharp increases in prices or the split of the Federation.

One of the points mentioned above, even though negative for the domestic companies themselves, can be viewed positively by a foreign investor. It is the secondary debt problem, created due to the lack of market liquidity and the cautiousness or unwillingness of banks to extend the already large credits. Banks refuse to extend short-term credits to many companies, supporting that the Czech Economy can hope for a long-term stability, only by forcing deficit-ridden companies to clear their books of "red ink" through liquidation. The government, on the other hand, was afraid of job loss and increased inflation, resulting from the one time liquidation of many companies. Therefore, the opportunity to acquire -below cost- an indebted company is attractive to a foreign investor. The main point is that most of the indebted companies, found themselves in such an situation not so much because of their production, but because of mismanagement during 1989-92 and the tied economic policy during that period. Therefore, many companies have reasonable production lines that can be further modernized. The industrial sector offers mostly long term benefits since large investments in technology and reorganization needed to be made.

As far as the liquidity problem is concerned, as was shown, commercial banks have the capital necessary for investments. There are three primary reasons for

their reluctance to invest in companies. First, it is a lower confidence in certain business and its success possibilities. During the current transformation period, banks are difficult to be persuaded about a future success of a business. In addition, bank employees are not trained to think in an entrepreneurial way, and can not assess possible opportunities. Finally, trying to build enough reserves to protect themselves in case of bankruptcies, banks often times as the largest shareholder are reluctant to extend further credits to businesses already in debt. Nevertheless, being a foreign subsidiary means having a much better credit rating than a domestic company. It provides the advantage to obtain financing domestically and not to rely on imported capital.

Construction companies, in comparison with other manufacturing firms, have no production lines, and their primary assets are their employees. Therefore, an investor does not need to engage in long term investments, which require a substantial inflow of capital in addition to the amount needed to acquire a company. It might seem that there are no short term benefits in the construction, this is not true. In consideration for short term benefits obtained from possible acquisitions, foreign construction companies should look beyond the infrastructure and energy markets even though they are the most promising areas of development. The primary short term gain for American companies is the access into the Common Market.

Czech construction companies possess the benefit of low cost operations and this advantage allow them to compete in Europe. They possess also the necessary engineering experience and skilled labor force. They lack the knowledge, managerial skills, and the experience of western markets. These are exactly the qualities which can be supplied by American companies. Rather than entering the difficult markets of the EC directly, an American company can pursue and entry through the Czech Republic and take advantage of the initial low production and acquisition costs, and of the subsequent engineering expertise.

Companies producing construction materials offer both long and short term benefits in comparison to engineering companies. One reason is the initial low production cost and -most of the times- the relatively cheap technology in comparison to the rest of the manufacturing industry. This makes construction materials very competitive on western markets. Another reason is the increasing construction demand

of construction materials in the countries of central and eastern Europe. Finally, the proximity of the Czech Republic to the EC reduces transportation costs. Already, many of the large construction materials companies have either been acquired or have formed joint ventures with foreign partners. Other have acquired licences from overseas producers, which realized that their products will be more competitive if manufactured in the Czech Republic rather than in the EC. Because of the long and short term benefits construction offers, the amount of investment it has received so far, exceeds that of any other industry.

## **Part 3.**

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### **1. PRIVATIZATION AND THE CZECH EQUITY MARKET:**

The process of privatization in the Czech Republic, although controversial at first, is now regarded by most as a model for privatization in the region. The government sold at nominal prices, almost half of its industrial holdings to Czech citizens in the "First Wave" of the "Large privatization" process. Most of the remainder of the Czech industry and agriculture was sold by the same method in the "Second Wave" which started on October 1, 1993. The system has succeeded not only in transferring ownership extremely quickly, but has established a relative value for shares through the five successive rounds of bidding with vouchers. Thus, the value of each company is based on the perceptions of investors (Investment Funds and private individuals), rather than on any financial data. The establishment of relative initial prices was important for the equity market. Thus, even though the initial prices did not correspond to the reality, they provided a benchmark, on which basis trading could start.

During the First Wave, and for the whole Federation, about 1400 companies were privatized with a nominal value of Kc 300 bil. Out of this number, 987 companies were Czech (71%). From the total population of 15 mil., 11 mil. of citizens were allowed to participate and 8.5 mil. actually did. The largest companies were privatized during the First Wave, whereas the Second Wave offered predominantly smaller businesses, and unsold stock from the First Wave. For the First Wave, 75% of the potential shareholders have transferred their investment points to Investment Funds. and received in exchange shares of the fund itself. Subsequently, the funds themselves bid for the companies being privatized.

The Second Wave, this time only for the Czech Republic, offered 770 companies with a nominal value of Kc 145 bil. Citizens have bid for shares using investment points which they bought for a nominal price. Thus, every citizen was entitled to buy a "book" of 1000 points for a price of Kc 1000. For the Second Wave, 6.8 mil. of such "books" were available and more than 6 mil. actually sold by December 8, 1993 (the deadline). The difference from the First Wave was, that this time not only Investment Funds, but also Mutual Funds alone could take part in the privatization

process. Nevertheless, many of the existing Investment Funds have already had Mutual Funds under management even before the Second Wave.

Once a citizen acquires the 1000 point book, he or she will register at the Center for Securities and will receive a computer account. Thus, once the five bidding rounds are over, each investor will have his "virtual" shares stored in a computer account. The same procedure exists for the Investment Funds who hold blocks of shares from individual investors. Any brokerage company or foreign investor have also register themselves at the Center of Securities in order to be able to buy or sell securities. An account statement from the Center for Securities will substitute actual shares. Thus, as in other countries in Europe, a "dematerialized" trading takes place. Nevertheless, the computer statements, are just confirmations of ones holdings, and can not be therefore traded.

The share prices in terms of investment points required per share were being constantly adjusted throughout the five "rounds" of the bidding process, depending on demand and supply. Thus, for example, the initial price for all companies in the first round of the First Wave was set at 33.333 points per share. The number is simply the ratio of the nominal value of all the companies sold divided by the total number of investment points sold. Subsequently, after the five rounds, one could see how the price per share in terms of investment points changed. For example, the average price per share in investment points after the fifth round was approximately 165. The five rounds, and the allocation of shares was performed in accordance with three simple rules:

1. if during the first round the demand was for less than 100% of shares of a particular company, everyone would be filled, and the remainder would go to the second round at a lower price;
2. if the demand was for more than 120% of the shares, no one would be filled, the points would be returned, and the company would continue in round two at a higher price;
3. finally, if the demand was between 100% and 120%, all the individual investors received full allocation, Investment Funds were scaled down, and the company would not go to the next round.

This process of receiving bids from individuals or institutional investors, and either allocating shares or altering prices when demand exceeded supply, resulted in equilibrium pricing. Thus in the end, virtually all

investment points were spent and 97% off all shares designated for sale were allocated. The remainder was offered by the Fund of National Property on the Stock Exchange or in the Second Wave. After the bidding process was completed, the Legal Title of shares was transferred from the Fund of National Property (the actual owner of all the companies created to represent the state) to accounts of individual shareholders and institutional investors. This signaled that the world's biggest corporate sell-off was completed (\$10 bil. of property for the First Wave) and actual trading could start on the RM System (a computerised OTC market) and the Prague Stock Exchange.

### **INVESTMENT FUNDS:**

As mentioned earlier, about 75% of shareholders transferred their coupons to the 437 Investment Funds during the First Wave. Predominantly, all the major Investment Funds have been established by major banks, to manage the investment of voucher points for their client shareholders. Many of those Investment Funds, have already had Mutual Funds under management, before the Second Wave. Others have created them especially for the Second Wave, when individual investors will be able to invest their points not only to Investment Funds, but also to the more specialized Mutual Funds. The funds are closed or open-ended and their shares will, or will not be tradable on the Stock Exchange. Share ownership is highly concentrated in the hands of the ten largest funds. They collectively manage approximately 40% of all equity privatized in the First Wave. In order to entice citizens to into depositing coupon points, funds have often promised unrealistic (100%- 500%) increases in share value within the first year of trading. If, however fund's share holders decide to redeem their shares which have been bound by this promise, it could mean bankruptcy for many Investment Funds. This may be also supported by the fact that most of the funds are literally "all shares", and without sufficient capital. In addition, due to the large number of Investment Funds, it is expected that about a half of them will go bankrupt, and will be consolidated with stronger funds.

### **THE RM-SYSTEM:**

RM System, is a private company established by a former state hardware and software company PVT. Its main objective is to serve the large number of individual investors who do not want to use brokerage

services. The same computer system that collated voucher bidding, and is acting as the central registration, has been transformed into a private company that will act as a fully electronic trading market. It could be compared with an OTC market, where every citizen or legal entity who has an account at the Center for Securities (owned by RM System), is allowed to trade. It started functioning on May 24, 1993, when for the first time buy and sell orders for the privatized companies could be submitted. However, how the initial price of a company was established, in order the trading to start? The initial number of shares for each company was simply its book value divided by 1000. Then, for each company, the initial price was computed as a weighted average of the company's prices in investment points, in all the five bidding rounds. Thus, after the fifth round which set the price per share of each company in points, and the assumption that 1000 points have a value of Kc 30 000 (from the number of points sold and the nominal value of companies privatized), the price in Kc per share was set. In addition, for the first trading session, in order any transaction to be completed, the value of any company share was allowed to fluctuate +20% from the indicated price. It is interesting to mention that the most expensive shares were at Kc 30000 (~\$1000) and the cheapest at only Kc 60 (~\$2). Also, it has to be stressed that the initial prices were estimated only on the basis of the book value of each company, without taking into account any financial indicators, which would be hard to obtain. Whereas until September 1993 the trading on the RM -System was being performed only ones every three weeks, starting September 1993, there is a possibility of daily trading. This is especially important for Investment Funds and brokerage companies, who do not have to wait until all the orders are collected and accounts of participants checked. Also, their buy orders are not constrained by the maximum price limits of the shares. This way the RM-System eliminated the largest disadvantage it had in comparison to the Stock Exchange, adding the interesting, however perhaps useless feature of unlimited bid price.

### **THE PRAGUE STOCK EXCHANGE:**

The origins of the first exchange in Prague date back to 1850's, when currencies were the principal trading product. The exchange for trading securities and commodities was established in 1871. It functioned until 1938, when official trading was

suspended. After the Second World War the operations of the Stock Exchange were not resumed, and the Exchange was officially abolished in 1952. In 1990, the Central bank (the State bank of Czechoslovakia) put into effect an initiative aiming at the revival of the Stock Exchange, as an inevitable step in the process of transformation of the economy. Eight banks became members of the preparatory committee on the Stock Exchange Foundation. In 1992 this institution transformed itself into a real Stock Exchange. On November 24, 1992 Stock Exchange Prague Ltd. was registered in the Business Companies Register. Twelve Czech and Slovak financial institutions, and brokerage companies became its founders and shareholders.

The Prague Stock Exchange opened on April 6, 1993. The first shares from the privatized companies were, however, traded on June 22 (one month later than the RM-System). The existing Prague Stock Exchange is modeled on the Paris and Lisbon bourses, and the software that runs its computer trading system was supplied by the French. It is able to perform 100 000 transactions daily of 1500 securities. Its trading system is based on concentration of supply and demand at a specific moment. Quotation of prices, matching of orders and the market price of individual securities is done automatically. Clearing and settlement of transactions is performed by the Stock Exchange Securities Register LLC, a subsidiary of the Stock Exchange. The clearing is carried out by the Czech national Bank in its clearing center. Shares and seats at the Prague bourse are open to foreigners. Even though almost 60 brokers are registered with the exchange, towards the end of 1993 the interest in equity trading increased so much, that their number is insufficient to cover the demand. In order to be a member of the Stock exchange, in addition to the initial fee of Kc 600 000, one has to pay an annual fee of Kc 150 000, and to contribute to the Guarantee Fund proportionally to the volume of transactions performed. One of the problems is the low volume traded which is around Kc 500 mil. per week. This results in the Exchange functioning only twice a week (Tuesday, Thursday). In addition, only about half of the 622 companies privatized in the First Wave are being traded on each session. Both the volume, and the number of companies traded fluctuate considerably, and therefore any conclusions based on these numbers would be inaccurate.

Up to June 22, 1993 when for the first time the shares of the privatized companies could be traded on the Stock Exchange, primarily government bonds had been traded. The first day of equity trading saw 622

unlisted companies available for trading. Nevertheless, only six of those were traded. Their initial share prices were computed in accordance to a similar algorithm used by the RM- System. The initial price was allowed to fluctuate +20% for the first time a share is traded, and by 15% during the subsequent transactions. Nevertheless the initial prices of the unlisted shares were much higher than on the RM-System, and up to today, there is a considerable difference in the prices of the two trading systems.<sup>1</sup> Analysts say both secondary exchanges (RM-System and the secondary market of the Stock Exchange) resemble the over-the-counter stock market in the United States, where share issues are traded, that do not meet the financial requirements for listing on the New York Stock Exchange or similar bourses. As the principal function of the Stock Exchange is to organize the market for listed securities, the question arises, which of the two unlisted trading systems will prevail. Nevertheless, the Stock Exchange plans to list about 30 companies until the end of 1993. Thus, further listings should differentiate companies, and consequently each trading system. In addition, the listing would certainly help the influx of foreign investment, since there is still not enough information about the privatized companies. It would increase the confidence of foreign investors towards the Stock Exchange, and the companies traded. Listing requirements call for a two-year audit, a Kc 10 bil. minimum capitalization, and making the 10% of traded shares available for trading, rising to 25%. Serious companies which can meet the listing requirements will be therefore traded on the more regulated Stock Exchange, with minor businesses being traded on the RM-System. However, each company should try to be listed, as on the Stock Exchange it can obtain the necessary capital more cheaply than by raising debt.

In accordance to foreign consultants and investors, only about 200 companies of all those privatized in the First Wave will be attractive to foreign investors. However, the Czech equity market looks promising, especially as far as the construction sector is concerned. Investors are interested in shares of companies producing construction materials, as a large demand of construction works is expected. Already towards the end of 1993, construction companies were together with banks, hotels and some consumer goods companies those who showed the largest share price increases and volume traded.

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1. Profit (weekly business newspaper) 30/93



As was expected, during the first four months of trading, prices were mostly decreasing, especially of the large companies. Due to the immaturity of the market, there have been cases, where audited companies with proved financial performance were trading below their market price. As time passes, however, and more transactions take place, the prices are getting more realistic and the large industrial firms strengthen their positions. Nevertheless, despite the positive developments on the Prague Exchange in comparison to those of Poland and Hungary, it is commonly agreed that the investment needs can not be met only through the domestic market. But just how much capital can be mobilized from abroad is still an unknown. As the chairman of the largest commercial banks argues:<sup>1</sup> "There is a lack of domestic capital and a need for foreign investors. But knowledge of the country is low." "It is not adequate to expect that the domestic market can meet the investment with just relying on influx of domestically generated capital through increased economic growth."

## **ANALYZING COMPETITIVE COMPANIES:**

As mentioned, each privatized company required a valuation. To facilitate this process while avoiding expensive and time consuming "market" valuations performed by consulting firms, a book values was assigned to each company. The total book value of companies was Kc 445 bil. While most industrial investments that have taken place so far, as a result of lengthy negotiations with government ministries have been well above book value, these have been for some of the premier, high profile companies. There is no doubt that there has been a significant mispricing of companies, something that represents opportunities for investors. At the same time, however, information about those companies is hard to obtain, and the vast majority of shares possibly acquired, would not provide the liquidity required by western institutional investors. It is characteristic that most of the privatized companies decided not to declare any dividends for periods up to five years.

As was earlier shown, only an insufficient quantitative analysis of companies took place before the privatization process. Being an industrial country, the Czech Republic's contribution to the world trade is

not the 10 million market, but rather the industries which will develop there. For a potential foreign investor it is therefore, essential to analyze which industries can be expected to maintain a sustainable, competitive advantage. In order to determine which industries can maintain a competitive advantage, an understanding of the relationship between labor costs and productivity, or input and output is important. Generally, the industries in which a nation has a competitive advantage are those, whose value added relative to the average of the national economy is greater than the respective number for foreign competitors. I believe, that -among other- the construction sector and especially the construction materials industry fits in this category.

The analysis of the promising companies should be made both on the a qualitative and quantitative basis. The size of a company, or its book value are therefore the least parameters on which an evaluation can be based. Rather an analysis of the potential success of a company should be the determining factor. Therefore, even though the future of many companies looks still bleak, this may not be true five years from now.

Qualitative analysis will be very important during the coming years, as almost any financial information (good or bad), will be almost useless since financial norms could not have been established yet. Nevertheless, it can be suggested that German norms could be used, because of the historical connection of the two countries. Qualitative analysis can be performed with the help of Michael Porter's<sup>2</sup> model and its look on buyers, suppliers, substitute products, new entrants, and existing competition. In our case, the importance of this model comes from its relative rather than absolute nature. Porter's model, even though considered by many as a simplistic one, provides us with a tool that does not need many historical data and can function on a basis of relative comparisons of industrial parameters. Qualitative analysis may be even more important than quantitative, since it will take some time before the market forces will stabilize and reasonable predictions can be made. Quantitative analysis, on the other hand, based on the standard Leverage, Liquidity, and Profitability analysis of the Balance sheet and the Income statement can be compared with European norms. Thus, each company's economic performance, would be valued on

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1. Michael Rothschild, IFR EBRD Report 1993

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2. Porter Michael, The Competitive Advantage of Nations, New York: Free Press, c1990

the basis of its comparison with similar European companies. In addition, projections can be made, keeping in mind, however, that the environment is still not stable. The information obtained from the analysis after being compared to other companies in the country, and western companies (especially German and Austrian) can provide a basis on which a fair market price is based.

Even though the Stock Exchange has been functioning for almost a year, the prices are not stable and has to be regulated by the 20% margin. In the case of bonds, the explanation seems to be the inexperience of investors, the relatively small number of bonds traded, and information outflows which sometimes result in insider trading situations. All those parameters have as a consequence high volatility in bond prices. In the case of stocks (either it is the more expensive stocks of service companies, or the cheaper ones of manufacturing companies), the volatility can not be explained otherwise than due to speculation. Investors, being not able to obtain enough information about the economic performance of traded companies, and needing to improve their liquidity define stock prices solely on the basis of demand and offer. In general, however, both bond and stock prices are increasing.

## **OPPORTUNITIES FOR CAPITAL INVESTMENT:**

In comparison to FDI, the Stock market offers many short term opportunities. Those can be found predominantly in the developing service sector, but also in construction, and some times even in the manufacturing sector. Except for services, especially promising is the construction materials industry. Construction materials companies have both short term, and long term potential for large profits. The short term potential comes from exports of low cost produced materials to the EC, whereas long term profits are secured by the large developments needed to be done in central and eastern Europe.

The service sector, and especially banks and hotels offer so far the largest returns and growth. Their share prices are consequently the most expensive ones. Another category is composed of companies whose stocks offer low returns, but promise sustainable growth. These include manufacturing companies with participation of foreign capital, construction materials companies, and some prestigious consumer goods firms. It should be pointed out, however, that foreign

participation by itself in a Czech company does not secure a high price of its stock. More important is a company's ability to attract foreign customers and capitalize on them. This is the reason why hotels show the highest prices on the Stock Exchange. For construction and manufacturing companies it means that, unless they are able to penetrate western markets, the interest of institutional investors in them will remain low. Also, on the basis of this argument, the differences in the stock prices can be explained. Thus, construction materials companies, who successfully export their products are traded at much higher prices than construction engineering companies who perform their services predominantly on the domestic market.

Nevertheless, as the stock market is still in its birth, it is difficult to make any long term predictions. Volume traded is steadily increasing, and even though volatility is still higher than it should be (prices change by +/-20%), the relative prices of shares among domestic companies have been established. This has two consequences for a foreign investor. For those who had better knowledge of the country, or were risk takers and purchased securities before the market established "real" prices, it means profits, since most of the prices increased. On the other hand, for the risk averse, or uninformed investors, the delay does not mean a more secure investment, but rather a more expensive one, since risks associated with security investments have not changed.

Some foreign investors support, that companies should not go public, but rather reinvest all their income in order to modernize production. This, however, would not help the transformation situation as a whole, since a potential lack of securities (and especially stocks) would hamper the development of the Stock Exchange. Thus, many companies decided not to declare any dividends for up to five years in advance, while making their stock available for trading. This solution can be regarded as much more constructive, since it allows a company to concentrate on improving its operations, while at the same time its performance can be evaluated by investors on the Stock Exchange.

Consequently, investing in the emerging Czech Stock Market, provides an investor with larger returns, valuation, and a diversification of their portfolio than other EC markets. Because emerging markets are considered more risky than the established western markets, and because their volatility is higher, they offer higher returns. In the same regard, the prices per

share are lower in comparison with the developed markets, not only because most of the companies are still underpriced, but also relative to their financial performance. This will become more clear, when the recently privatized companies will be fully restructured, and start functioning at their full potential. Finally, given the different parameters that influence the Czech market (and the markets of central Europe in general), a foreign investor can obtain sufficient portfolio diversification. The diversification will not, however be a valid argument for long time, because even if the Czech market is not yet correlated with its western neighbors, it is expected that it will become by the year 2000, given the close relations it has been building with those markets.

## ***Part 4.***

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### **1. FINANCIAL RISKS:**

Three are the main types of financial risk: Foreign currency risk, risk associate with government financial regulations, and risk related to the economic performance of a country. Each of those can be addressed with one or more financial strategies, involving current asset management and short, medium, and long term financial techniques.

### **FOREIGN CURRENCY UNCERTAINTIES:**

The Czech Koruna came into existence on February 8, 1993 with the demise of the Czechoslovak Koruna. Although the two republics intended to use the same currency through July 1993, concerns about speculations on hard currency reserves, and the emergence of two separate Central banks pursuing different monetary politics accelerated the division process. Initially the two independent currency units were valued at an 1:1 exchange rate. As time passes, however the Slovak currency loses its value. The Czech Koruna is neither fully convertible nor free floating. Under the internal convertibility system, companies have free access to hard currencies, but are obliged to convert their export income into Korunas at the prevailing market exchange rate.

On January 1, 1991, the CSFR government instituted internal convertibility of the Koruna for investment and commercial transactions. This meant that importers and investors could freely buy foreign currency for current account transactions. Investors who are Czech legal entities may convert profits earned in Koruna's to other currencies in order to pay dividends. Foreign investor companies are required, however, to hold all currency in the country in Koruna. The banks must make hard currency immediately available to those companies for profit repatriation, or to pay for imports of goods or services. These conditions do not apply to the initial capital investment in a joint venture, which may be held in a hard currency account, and to which other exceptions may be granted.

As already mentioned, the currency is pegged to the USD and the DM. Even though the nominal exchange rate has been very stable in real terms (Kc 30 = \$1), there has been a significant appreciation, which

however, does not have a significant impact -as of 1993 - on exports. This can be explained by the deep devaluations in 1990 and 1991. In 1990 the currency devalued three times, by 18.6%, 55%, and 16%, followed by a 80% devaluation in 1991. These numbers indicate that there should not be any major future devaluation that would cause a change of the exchange rate. This argument could be supported by two major facts. The first is the government's aim to create a stable economic environment. The second is the commonly known fact that Czech companies can not compete in the long term on the basis of a low price. In addition, the stable exchange rate is a result of tight monetary politics, aimed at keeping inflation low, and creating a safer environment for foreign businesses. As the country's aim is to become a member of the EC it is expected that by the year 2000 the currency will be fully convertible and under the same regulations as the other EC currencies.

Generally speaking therefore, there should not be a large foreign currency exchange risk. Nevertheless, things will change once the currency will become fully convertible and floating. By that time, the economy should have stabilized with an inflation similar to that of the EC. However, companies should not rely on the temporal stability of the Koruna. Even though forward contracts are used only to a limited extent, and only by foreign banks, and derivative products are not common, a subsidiary could develop a hedging program based on more simple techniques. These could include a monthly reporting system for current and future exposures, development of information sources on currency movements, development of local investment strategies, investment in local expansion with debt rather than equity (however bank debt is still to expensive), reduction of local currency holdings, leading and lagging (in limited use), netting (there is not technical infrastructure to support it), etc. Other techniques which could be used, are more relevant to the domestic front which (due to the stable nominal exchange rate) has many times larger impact on the overall subsidiary performance. The lack of sufficient liquidity and the volatile inflation (a result of cuts in state subsidies, devaluations, VAT, etc.) are the two primary characteristics of the domestic market. Thus, negotiating payment schedules to suppliers, creating relationships with banks, selling receivables forward, or buying put options (if available) are some of the possible strategies a subsidiary could pursue.

## **GOVERNMENT FINANCIAL REGULATIONS:**

The Czech government is following as liberal economic policy as possible. Even during the high inflation which followed the abolishment of the state subsidies, there were not any price controls imposed. The same was repeated in 1993, after the VAT was introduced. It is reasonable therefore to expect, that in the future there will not be any such danger.

There are not any restrictions in capital inflow. Non residents and residents can borrow freely from abroad. Non residents can not, however borrow in foreign currency on the domestic market. Interest on foreign loans is fully remittable abroad. In the case of principal permission from the Central bank must be secured. There are not restrictions on export proceeds, but as with other forms of income these are subject to exchange controls, and have to be converted in Koruna. Foreign exchange is also readily available for import payments of any goods.

There are no restrictions on repatriation of capital, and banks are required to make foreign currency available for companies wishing to repatriate their return on investments. Allowable returns include cash from domestic investment, capital gains and earnings on securities. There are not as well any restrictions on remittance of dividends and profits. No approval is required. Dividends are subject to a 25% withholding tax, but in cases where there is a double taxation treaty signed it can be reduced to 0-15% (double taxation treaty has been signed with about 30 industrial countries). Royalties and fees are also freely transferable. The tax base on royalties is gross income without deduction of expenses. Government approval to pay royalties is not necessary. Transfers of royalties are subject to a 25% withholding tax. However, foreign private individuals are restricted to reconvert their gains from portfolio investments. Netting is also permitted by law, however, as in many other instances, the necessary technical infrastructure is not in place, and netting is not common.

Roughly speaking, the government does not make a distinction between foreign or domestic businesses. They are both allowed to function under the same conditions. Only foreign legal entities as opposed to private persons are, however allowed to acquire land. Nevertheless, the same treatment of all the companies is not always a plus. Even though all companies have equal access to credit, both foreign and local companies remain hampered by the currency

regulations preventing them to hold bank account denominated in hard currencies. In addition, there is a constant shortage of funds, since the most common way to obtain financing is through a bank loan, which are in high demand due to the tight monetary policy and the undeveloped stock market.

Even though the country does not have a long history of exchange control environment in accordance to which companies could set up their financial strategy, there is not any substantial risk of blocked funds. The government had always managed to keep the trade account healthy, and the foreign currency reserves on the required level. It is, however, helpful especially for the large companies to preserve a continuous relationship with the government and inform it of large current and future transactions.

For construction materials companies, repatriation of capital or dividend payments are not a major issue. Examples of foreign investment have shown<sup>1</sup> that most of the foreign investors, have not remitted capital abroad. Rather they reinvested any income, or even imported more capital in order to increase the volume and the variety of their products. Following this strategy, they target short term revenues from exports to western Europe, and prepare their production facilities for the construction boom which is expected in all the construction sectors. Those foreign producers who could not afford a direct investment, and whose production facilities are far from the European market (especially British and Scandinavian), sell licences to Czech construction companies, who then export to continental Europe.

## **ECONOMIC PERFORMANCE OF THE COUNTRY:**

The inflation predicted for the 1993 is around 17%. As already mentioned, the relatively high number is caused by the introduction of the VAT system at the beginning of the year. Thus, even though the current inflation is high, the per month number is running around 0.5% and the predicted inflation is 6%-8%. This number is expected to come primarily from wage increases and CPI rather than from the PPI. In addition to the predicted low inflation, there was also a reported surplus of Kc 300 mil. in the trade balance account at the end of the second quarter of 1993. All these

numbers show that there is not any reason to devalue the currency, or to impose import restrictions.

In addition, the Czechs have always been a very taciturn, and one could say even passive nation. This can be seen in the almost complete absence of strikes during the past four years of transformation. From this, and the general economic situation could be concluded that there is not any danger of economic or political chaos.

The foreign debt is also low, and the country shows an ability to repay its debts in advance. A possible disruptions in external financial relationships due to high debts or rescheduling, should not be therefore considered as a possible threat.

### **FINANCING COST-CREDIT SHORTAGE:**

The real problems in the Czech Republic is not the inflation, foreign exchange liquidity, external debt, price controls, capital flight (Czech banks offer on hard currency deposits higher interest than foreign banks), or economic and political chaos. The real problem is the Czech banking system, the Czech banks and the interest rates they charge on loans. As the capital market is not yet enough developed in order to be able to act as cash supplier, financing costs remain very high (in April 1993 the interest rates reached the maximum of 19%). Even though during the past it could be argued that this was a result of the tight monetary policy, the present situation starts to show a different view of the whole problem (see Monetary Policy on page 18). After the decrease by the National Bank of the discount rate by 1.5%, to 8% in June 1993, the five large commercial banks failed to follow. This could be attributed to several reasons. Commercial banks did not have the interest ceiling imposed on them, and were able to charge as much as possible, with an explanation that they have to build their reserves. This could be partially true, because they are the ones who made loans (in 1993 their receivables were about Kc 600 bil.) to companies, which are having debt problems, and are partially protected by government subsidies. In addition, the expected bankrupts could put an additional burden on the large banks, which try therefore, to build as higher reserves as possible. The other alternative view is, however, that the commercial banks (and the reference is to the big five institutions), are unable to run their businesses effectively. They may have new directors and top managements, but the great majority of their employees still work in accordance to the old practices. The restructuring of the banking sector has not really happened yet. What could be

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1. EKONOM 4/1992

argued therefore, is that the financing cost and the credit shortages are not so much of an economic problem, but rather managerial and administrative. Would the banks function properly, we should be able to see what the real shortage of capital and financing costs would be.

The implication for a construction company, which will want to be able to provide project financing to its customers are obvious. The company has to have a parent with an excellent credit standing with financial institutions. Thus, a foreign subsidiary will not be dependent on the banking sector for debt financing, but be able to take advantage of the existing debt instruments, in order to avoid extensive import of capital. This way only the subsidiary would be able to take advantage of the skilled labor and the low production costs, and offer services under the same terms (off balance financing for its customer, on time completion, etc..) as its western competitors.

The shortage of cash for operational requirements can be addressed by some of the following principles, which should help to insulate a company from the effects of cash shortage:

- Generate hard currency sales. This should be truth for any foreign subsidiary based in the Czech Republic. It should utilize the initial low production costs and export services at competitive prices. This has already happened in the case of construction materials companies who export large quantities of their products to the EC. In the case of Germany and Austria this resulted in quotas imposed on exports of construction materials.
- Borrow from the parent company (money is more expensive in the Czech Republic than in the EC). This is a good technique to acquire greater share in an JV business. If the domestic partner is heavily indebted, a further debt-equity swap can be proposed. This had already happened in the case of some construction materials companies. A foreign partner who acquired a minority stake in a business, took advantage of the large debt the domestic company had, borrowed from its parent and swapped debt for equity. Nowadays both sides are better off, with the foreign partner controlling the business and the domestic company debt free.
- Build and keep relationships with banks. Even though there are about 30 to 40 banks, the banking sector is dominated by five large institutions which are basically holdovers from the old times. This is especially important for a construction company interested in exporting its services. Only the large

banks are able to provide it with credit necessary to offer abroad the same services (e.g. off balance financing) as its competitors.

- Borrowing in local currency is expensive but could be better than running the risk of a devaluation. As mentioned before, however, there should not be any considerable devaluation risk, giving the condition of the economy. Nevertheless, since 1993 other instruments besides bank credit exists for debt financing. As the government and the large banks are constantly trying to improve the volume on the Stock Exchange, such a move will be looked upon favorably.
- Monitor receipts from the banks, which due to their ineffectiveness may delay to credit your account, even though the customer has already paid. This parameter should nevertheless be improving, as the large banks invest more and more in technology, and the smaller ones consolidate their businesses to offer better services.

## **2. FINANCIAL STRATEGIES:**

### **CURRENT ASSET MANAGEMENT:**

Even though the Czech Republic should not be considered as an inflationary environment, techniques can be used to manage the three basic components of Current-Assets. Nevertheless, in today's business environment of decreasing margins this is true for any economy. Thus, excess cash, receivable, and inventory can by themselves be considered as profit centers.

Cash transfers take place via a clearing system operated by the Czech National Bank. Delays in transfers are common, mainly from main bank offices to local branches. The problem arises because of inadequate on-line connection of commercial banks and their branches with the Czech National Bank (the Central bank). Companies nevertheless face no serious currency, inflation, or interest rate risks which would direct them towards a more rigorous cash management. Goods are generally sold on a 14-day, or 21-day credit term. Because of the liquidity problem, companies often require partial payment in advance, and in some cases offer discount terms.

In an inflationary environment, the parent company would require its subsidiary to keep excess cash at the lowest possible level. This can be achieved by increased dividend remittances, transfer pricing, interest charges on intracompany accounts, prepayments, etc. Assuming, however, that the

inflation for the Czech Republic will be below 10% during 1994, no such measures seem necessary in the near future. In addition, there are two other parameters which can influence the decision not to remit more cash abroad. One is the possible continuation of the liquidity shortage. The other is the need to expand, or further modernize a subsidiary. This is especially true for construction or manufacturing company which after acquiring a stake in a Czech business will have to make investments in employee training and technology. In addition, more capital would be needed for almost any company acquired in order to change its organizational structure, and to make it more efficient.

As will be shown in the section 5, some construction companies even attempt to invest their short term capital on the Stock Exchange. Even though from the western point of view this may be an unacceptable behavior, a knowledgeable investment on the Stock Exchange may temporarily help a company to finance its overhead. This is especially important for a construction company that does not have sufficient backlog, or can not secure construction abroad. As construction in the central and eastern Europe is certainly a sector with large future growth, it is better to operate today on a break-even basis, than to downsize a company and be unable to respond later to large construction demand. Foreign investors should know, however, that very few domestic construction companies are aware of this fact. Very few finance their business temporarily with small size constructions, or other means as the one mentioned above, which do not generate any profits. It can be expected therefore, that when the demand for large construction will substantially increase, a foreign construction company who will have established a subsidiary in the country will not face any serious competition.

Because of the current credit shortages and the high interests on loans, accounts receivables are perhaps more important than the cash management itself. If we consider a construction company working for a client in a region, where it does not want to finance and operate a project after its completion, the receivable collection has to be addressed. This may be especially important if the client is in the Middle East, or eastern Europe. A collection department operating with a reliable reporting system of all the cash flows, and having the ability to scrutinize potential customers could be established. However, if it is assumed that a construction company would be interested only in large projects financed by governments or international organizations, the question of receivables is secondary.

Domestically, collection terms are set in advance between the buyer and the seller, and payment are made via a bank transfer between accounts. Mechanisms for expediting payments had not evolved yet during 1993.

Inventory management may not be so important for construction companies as they do not manufacture goods. Construction materials companies in the Czech Republic have, in most cases, their own natural resources and therefore do not run any substantial danger of upstream price fluctuation. Also, as there are not any restrictions on capital repatriation, it can be assumed that as in any other European country, also in the Czech Republic a company would not want to finance extensive inventories. Therefore, the same systems which are used to lower inventories in order to decrease taxation or accounting costs should be used in the Czech Lands as well.

## **SHORT TERM FINANCING TECHNIQUES:**

Given the embryonic state of the capital market in 1993, banks relied heavily on short term financing. Three to six months credits accounted for almost all of the banks' loan portfolio. Short term loans were also less risky as there were a lot of new commercial borrowers, and little transparency in financial data. This situation is changing, however, as corporations are required to use the double entry accounting standards, and make their financial standing publicly available through annual reports. In addition, the Stock Exchange is more and more stabilized and the trading volume constantly increases.

Nevertheless, even in 1994, short term loans still prevail as the predominant mean of securing short term credit. Guarantees offered as collateral include consignatory agreements, property, blocked currency accounts, and lately securities.

Overdrafts were in 1993, 2-3% more expensive than the "fixing rate" set daily by the five large banks accordingly to their short-term rates (one of them, the Commercial Bank lowered its short-term rate to 11.9% after the decline in the discount rate to 8%). An overdraft takes usually a form of a revolving credit.

The rediscounting of trade bills was introduced by the Central bank in June 1992. However, in accordance to commercial banks, until 1994 the Central bank has not issued clear directives as to which bills of exchange qualify for the rediscount. Commercial banks have

than to run the risk of having their bills rejected, when trying to obtain the cheapest external financing available. The seller of the paper typically receives the money two days after the discount.

Commercial paper is slowly developing in the Czech Republic. Specific regulations and practices have not been established yet, and the lack of secondary market hinders the development of this practice. However, Creditanstalt Bankveiren issued commercial paper for Skoda MB carmaker. Also, in June 1993, Unilever Czech Republic issued commercial paper with a nominal value of Kc 600 mil., in order to finance its activities in the Czech Republic. The issuing and paying agent was ING Bank Prague (a subsidiary of NN.), and the payback period ranges from one month to one year.

Bankers Acceptances are not commonly used in the Czech Republic, as banks are already burdened with an extensive debt from corporations.

Supplier credit is generally granted for three weeks after invoicing. Interest rates are negotiated by the parties involved. Nevertheless, due to the liquidity problems many companies are troubled with, supplier credits are not granted as easily as they used to be. Supplier credit, however, remains the most frequently used mean of short term financing, after the short-term loans.

Intercompany borrowing is permitted by law, but due to the extensive intercompany indebtedness, it is not a common practice.

Factoring services are used mostly in exports. In order to be eligible for factoring services, a Czech exporter must have at his disposal an uncovered free credit, payment conditions must not exceed 180 days, and the exports must be designated for a country where factoring is available. Factoring is expected to expand domestically as well, as multinationals with large customer base enter the market.

As short term credit may be especially important for construction companies performing smaller construction, the above suggest that Commercial paper is the best way to obtain short term financing. Other means may include rediscounting of bills. Supplier credit may be of a value for construction materials companies, but has small value for construction engineering companies due to its short term character. Nevertheless, as construction is a sector where medium and long term financing prevails, availability of short term techniques should not play a major role in an investment decision.

## **MEDIUM AND LONG-TERM FINANCING:**

In theory, the medium and long term financing is available from both commercial, and savings banks. However, because of the long term uncertainty over interest rates, the excess of credit demand (due to high interest rates and less due to the tight monetary policy), and the lack of long term deposits, banks prefer short term credit. Long term credit is provided mostly by international institutions (World Bank etc.). Nevertheless, in addition to international institutions, medium and long-term loans can be obtained more easily from the Commercial Bank and the Investment Bank (the two large banks out of the five). The construction sector in particular has an advantage over manufacturing in obtaining loans from international institutions due to its developmental nature. In addition, construction can usually offer better guarantees to commercial banks than manufacturing or other services, and can therefore obtain bank loans on better terms.

Notes are still not widely used, because of the undeveloped financial markets. Nevertheless, they can be arranged, and their use is expected to increase, once the second wave of the "Large privatization" is completed in 1994.

Leasing has become widely used, given the shortage of medium and long-term financing, and the high interest rates on loans. The number of leasing contracts rose from 300 in 1991, to 4000 in 1992, with a total volume of Kc 4 bil. Even though the law governing the leasing operations makes no distinction between financial and operational leasing, it specifies depreciation schedules and tax regulations for five different categories of assets. Vehicles, know-how, and computer equipment are depreciated over four years, plant and equipment over eight years and buildings over fifty years.<sup>1</sup> The duration of the contracts must be three years or at least 40% of the depreciation schedule. Foreign lessors are liable to a withholding tax.

Leasing could be an attractive option for a construction company active in the Czech Republic, even though a local subsidiary of a large foreign parent would rather prefer having its own equipment. However, since modernization of equipment could be necessary after acquiring a local construction company, operational lease could prove to be a more

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1. EKONOM 8/1993



efficient manner of financing such a modernization. In addition, if the demand for large constructions would be further away than expected, lease purchases could be financed with some of the break-even financial strategies previously mentioned.

Mortgage loans are becoming more common as apartments and buildings are being returned to private owners. In the case of medium and long-term loans a collateral in the form of real estate property is usually required. This is an attractive option for a construction company involved in reconstructions (in 1993 and 1994 the most profitable construction sector). Czech and foreign Banks know the high value buildings have in city centers and are willing to provide financing, since their returns are assured

Corporate enterprises are authorized to issue bonds, and their number is constantly increasing with the increasing activities on the Stock Exchange. The bond market is evolving as the first subsidiaries of foreign corporations start issuing their own bond issues, and is considered the most efficient mean of obtaining domestic financing.

Swap financing even though not common (Czech banks had not have any experience with swaps as of 1993), is offered by foreign banks. Fixed-to-floating and floating-to-fixed swaps, as well as forward-rate agreements, of as long as a year for the local currency are performed. Longer periods are available for foreign currencies. Even though there has not been a significant number of these contracts, things will certainly change, as domestic corporations and Czech banks will become more accustomed.

## **SHORT TERM INVESTMENT INSTRUMENTS:**

The most popular short-term instruments include time deposits and certificates of deposits. During 1992 and 1993 the government had also started issuing Tbills. As a consequence, an overnight, one-month and three-months market had emerged.

Time deposits are available from 1 to 12 months, with interest (around 10% in 1993) changing as the Central bank adjusts its discount rate. The yield curve is positive. Interests on deposits are lower than the current inflation, but higher if the one time boost in prices due to the VAT system is subtracted. This suggests that the future inflation will be below 10%. In addition, the third issue of government bonds (in 1994)

will also carry a coupon of 10% (down from 14.6% in 1993) indicating the decreasing inflation.

Certificates of deposits are issued by commercial and savings banks, for different terms and in varying denominations. The Yield curve is also positive.

During 1992, an overnight, one-month, and three-month money market emerged. Volumes are constantly rising, with daily turnover in the overnight market during 1993 around Kc 4 bil. The internal foreign exchange market has been in operation since January 1, 1991, and is used to support the system of internal convertibility.

Treasury bills are being issued by the government since February 1992. Maturities range from one to three months, but are available only on large denominations of Kc 1 mil. and more. Rates stay close to the discount rate, and indicate that the future inflation will be below 10%. Tbills are purchased predominantly by commercial banks, but other institutions as insurance companies and funds will be permitted to trade these instruments as well. The secondary market for Tbills is active on a daily basis.

Bankers acceptance and Commercial paper are limited in use due to the almost non existent secondary market. However the market started developing in 1993, with multinationals issuing the first short term obligations.

As can be seen it is only a question of time when all the usual investment instruments will be available, companies will have more options to invest their short term capital, and banks will have to lower their spread. Short term investing should be more important for institutional investors than companies since companies will have to invest in their own operations. However, industries such as construction where large demand is expected should use the available short term financing techniques for overhead and working capital purposes.

## **3. ECONOMIC RISKS:**

Even though economic indicators do not seem to be very encouraging, they have to be looked upon throughout the past four year period. Thus, GDP growth may be only around 1% for the Czech Republic in 1993, but it was -15% in 1991 and -8.5% in 1992.

Inflation may rise up to 18% in 1993, but the number contains the one time increase by 8.5% due to the new VAT law. The predicted inflation for 1994 is around 8%. Again, the high 1993 inflation could be

compared with the situation in 1991 when inflation reached 52.1% due to the abolishment of state subsidies. A year after, in 1992 inflation was 12.7%, a number which includes the political uncertainties about the Federation split.

The Current account was predicted to be slightly negative in 1993, due to negative trade balance. However, as already mentioned, at the end of the second quarter the trade balance was \$300 mil. positive. As a result international reserves are rising constantly. This performance is attributed by many investors to the policy of maintaining stable the Koruna. The external debt is the lowest of all the countries of central Europe, and the government is able to repay many foreign debts before their maturity.

Even though industrial production in real numbers was increasing during 1992, the first quarter of 1993 showed a 5.7% decrease. This decrease was caused, in addition to the uncertainties about the split and the VAT, by a lower number of working days. Other estimates<sup>1</sup>, show the industrial output declining only about 2.1%, with some showing even a small growth. Therefore, the results showing a decline of production have to be looked upon cautiously. This becomes more obvious, if one observes the state budget surplus, and the low level of unemployment. In addition, it is suspected that the growth of the new private sector is much rapid than suggested by official statistics. This would imply that the estimates should be more favorable. Nevertheless it is more probable that industrial production showed in 1993 a slight decline in comparison with 1992. As commonly known, industrial production will start growing only after companies will be restructured, and will not employ in excess of their needs.

Even though Czechoslovakia used to be an exporter of machinery and generally finished goods, this is not true anymore. Besides the decrease of the Czech Republics' share of the Worlds' exports, the structure of its exports has also deteriorated. Even though research showed (as early as during the 1960s) that exports composed of raw materials and semifinished goods will not increase the overall exports, this situation had not change as of 1994.<sup>2</sup> The decreased exports are accompanied with increased energy imports. Thus, in 1993, 19.4% of foreign currency earned from exports was spent on imports of crude oil

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1. EIU Country Report 3rd quarter 1993

2. HN 4.14.1993

and gas necessary for raw materials production. On the other hand, a very low portion of foreign exchange earned from exports have been used for imports of machinery and generally technology necessary for industry transformation (the figure should be about ten times higher). The underlying risk is therefore, that unless the country starts producing and exporting goods with higher value added, it will remain technologically within the range of developing countries.

Fears of sharp rise in unemployment proved to be exaggerated. Whereas in 1992 the unemployment was about 2.6%, during 1993 it should not exceed 4%, and in the future it will be under the EC average of 9.8%. This development is primarily attributed to the fast developing service sector, which is absorbing many of the lost jobs. In addition, a lot of Czech nationals are working for foreign companies abroad as well as domestically. The construction industry is another example that shows why there will not be large unemployment in the country. Even though many of the large construction companies shrunk their operations and reduced their work force, many new small and medium construction firms were formed that offer employment to the former state workers.

#### **4. OPERATING RISKS:**

Besides the inefficient banking sector, there is also the legal structure, which proves to be frustrating for foreign investors. The enforceability of contracts, trademarks, and copyrights is difficult because of the number of completely new laws, which many times take multiple interpretations. In addition, the unpredictable bureaucratic behavior of state services is connected to the fact, that on lower levels, offices are being directed by the same people as in the past, who are unable or unwilling to change their behavior. People have difficulties with understanding and interpretation of "western behavior". Thus, in the Czech Republic "history" have created people with an anti-market behavior, which is sometimes characterized as "rude" (when someone behaves as it used to be the case during the past 40 years), and sometimes as "funny" (when there is a honest attempt to behave accordingly to the "western Principles"). However, the Czech Lands have historically been a part of the western Europe, and it can be expected that with the increasing influence from the EC, and the interaction with foreign cultures this problem will gradually fade away.

## **FINANCIAL VERSUS ECONOMIC RISKS:**

As the Czech economy is still not stable, the risks associated with a potential investment are not negligible. Leaving aside the political risks which are probably the same as in other EC countries, and the operating risks against which little can be done, two are the predominant areas of concern. Those are the Financial and Economic risks.

Financial risks should not be regarded as significant, as the major devaluations have already been made, and the currency is still not freely convertible and floating. Nevertheless, the stability, which the currency shows will certainly change in the future, with the increased approximation to the EC. When the currency will become fully convertible abroad, it will have to resist the same market conditions as any other European currency. This implies that as long as the Koruna is not freely floating and convertible, the exchange rate risks are reduced.

The government is following a liberal policy with no blocked funds or repatriation risk. There are no restrictions on foreign capital except for the required exchange rate conversion of export proceeds, or interest tax on foreign loans (Germany had the same tax until 1984), which are nevertheless in line with the government's economic policy. The same financial techniques are available, as in the rest of Europe, even though they are still not widely used. It is, however certain, that their use will extend with the completion of the privatization process, and the increased experience commercial banks will acquire in using those techniques. In addition, the country as a whole shows better performance than the other central European countries, which attempt to increase their performance in some attributes of their economy (GDP, productivity), leaving other unattended (unemployment, inflation).

Much more alarming are the possible economic risks associated with the uncompleted privatization and restructuralization, problems with liquidity, and the intercompany debt. Intercompany borrowing has been on decline (even though there is tight liquidity), due to the risks it carries. Supplier credit is not granted as easily as before, again due to liquidity problems. Even though there is no doubt that many companies facing secondary debt problems should go bankrupt, we have to distinguish between bankruptcy which means restructuring and further operations, and bankruptcy which means dissolution of the company. This is not to

imply that all the companies should be -one or the other way- saved, but rather to indicate that a total dissolution of a company means losing the skills associated with the particular production. Being aware of this, and other problems associated with a possible dissolution of a company (legal, administrative), the government protects as many companies as possible. Foreign investors who are willing to engage in a longer term investment have, therefore, the opportunity to acquire an indebted company at a very low cost. This may not be the case few years later, when companies that are currently weak will not exist, and the stronger ones will be much more demanding and expensive. An example are the large construction materials companies which almost all have by 1993 secured foreign capital participation. Thus, when the Stock Market started functioning in 1993 there was a large competition for the few remaining construction materials companies.

Finally, a potential foreign investor, does not need to import all the capital needed in order to restructure an acquired company. As have been shown, the financial vehicles are present, and the first large multinationals with excellent credit ratings are able to raise domestically the needed capital. As there are still not enough options for short term investment of liquid assets, and the stock market is not mature enough to support large investments, a foreign company with good ratings should be able to raise the necessary capital for restructuring and further operations domestically, by raising debt. With the stock market fully functioning, it is certain, that domestic investors will value such an opportunity, since it offers an improvement of their portfolios, and a prospect of short term gains. International investors, on the other hand, will regard an offering from a foreign subsidiary as an opportunity to invest in an emerging market. As mentioned in part 3, such an investment promises higher returns with almost the same risks as in developed markets, and a portfolio diversification.

## 5. FDI - AN ACQUISITION PROPOSAL:

### EXECUTIVE SUMMARY:

If we consider a fictitious construction company with the following Mission Statement:

- To be a leading global construction company with a strong basis in both the US and Europe, from where it can provide complete services on a global basis.
- Secure sustainable growth, and increase its shareholders' profit through proper planning and control.
- Focused on large projects in infrastructure, energy and environment, but having expertise to deliver quality on time.
- Able to guarantee a project, and to offer project financing and project management after a project is completed.

The US have many large construction companies, experienced in the international markets. However, US construction companies (and in contrast to other large US corporations), generally failed to be global players through an adequate international presence. If our fictitious company is to follow its mission statement, and become an international player, it will have to diversify geographically. Even though it might not be appropriate for a construction company to have a subsidiary in each country, a global player should be present at least in the two (out of three) trading blocks which are about to form. Therefore, having a strong presence on the European continent is essential, in order the company to be able to access more easily the markets of the Middle East and Europe itself. Especially in the case of an European location, there are three important aspects relevant to market accessibility:

1. Better access to the new central and eastern European markets, a huge market especially for Infrastructure, Environment and Energy. Even though in short terms those markets are not much promising, long term opportunities are certainly there. It is important therefore, to establish a local presence in order to develop relationships and to obtain information.,
2. Access to the European Community which has been traditionally closed to American companies and where opportunities are developing with the

European integration. In this aspect, it is important to locate a proper base, where the impact of the various protectionist measures would be minimal.

3. Better access to the Middle East region which will always be a focal point as long as there is oil. It is more preferable a company to be based in the political stable, and communication efficient European region, from where it can easily access the Middle East, than to attempt to establish a permanent presence in Middle East itself.

However, where in Europe should a permanent presence be established, what would be the cost of establishing a strong presence in Europe, and under what form? The benefits offered to the parent (as technical expertise, technology, operating costs) in connection with any acquisition cost, should be the two parameters used in evaluating the possible location of the European subsidiary. Excluding the western Europe which (with the exception of England) has always been too much competitive for American companies, or where too many restrictions have been imposed on operations, opportunities have arisen in the former East Block countries, and especially in the Czech Republic, where (in accordance to American and German managers) the industrial sector is in better condition than that of Poland or Hungary.

However, why Europe and not Asia or Latin America? What is the advantage Europe has been offering, and still offers that drives American business to invest there. It is the higher incomes, and consequently higher returns relative to risks, something that also means shorter payback periods. There is no question that east Asia, Latin America and the countries of the former Soviet Union offer a huge potential market for construction. Nevertheless, the financial resources available from the World Bank, the EBRD and other institutions are not sufficient. They can not support a long term strategy on which a construction company can base its future growth. If a product can not be taken out of the country in which it is produced, and sold on developed markets (as oil, gas, or other natural resources), the country itself has to be economically developed in order any project to be profitable. For example, building a motorway or a power station means, that after its completion either tolls or electricity will have to be sold, and in most cases will have to be sold to the domestic market. If that domestic market does not have sufficient buying power, the revenues will be small, and the payback period so long, that the whole project will prove to be inefficient.

If what is mentioned above is true, then why would someone want to invest in the Czech Republic? He would not, unless the country would be regarded not so much as a potential market, but rather as a base from where other markets can be reached. Thus, whereas for an American company it is difficult to penetrate the EC market from any of the member countries (with the exception of England), it is much easier to penetrate that market from the Czech Republic. Czech companies are already active in Germany, and the association treaty signed with the EC, will further strengthen the ties between EC countries and the Czech Republic. In addition, such a permanent presence enables to obtain information and access to the east European region and the Middle East where lot of Czech companies have done projects in the past. Establishing therefore, a permanent base in that country, enables to penetrate effectively the rest of Europe, and have access to the rest of eastern Europe, and Middle East. This can be achieved without any political risk, or high economic cost, as would be the case in other countries, and with the availability of a skilled engineering and labor force. This does not mean that there are not opportunities to invest in construction in the Czech Republic. There are, and perhaps more profitable than in the rest of the central Europe, since the country is from a communication point of view, the gateway to the rest of eastern Europe. This would mean, that revenues from a possible construction would come not from domestic consumers, but rather from foreign companies, and individuals interested in doing business in eastern Europe. Thus, some international construction companies have already entered the Czech market, offering construction management and consulting services. Nevertheless, the following four attributes should be considered when evaluating the country. They are economic, historical, geographical and societal (developed in the Conclusion section of the paper).

In the Czech Republic, companies with strong technical expertise, but also often with a lack of the sufficient technology and appropriate “western style” behavior have been looking for western partners. They offer lower production and material cost with high technical expertise and skilled labor force, and seek partners with technology, managerial know-how and ability to obtain credit. Currently construction companies face shortage of sufficient skilled labor, because a large number of construction workers are employed in Germany, where larger wages are offered. The low cost production platform should be, however,

regarded only as a short term advantage, since costs are constantly rising. Rather, attributes as technical know-how, more liberal approach to foreign investment than the EC countries, proximity to the rest of Europe and balanced economy should be regarded as the most important characteristics. Low production cost will provide the initial boost, but other factors will determine the long term growth and prosperity.

If decided to base a business in the Czech Republic, under what form this should be? Should it be joint venture, or any type of a merger (Pooling of interests, purchase acquisition or consolidation)? An effective joint venture can be achieved only between companies with similar cultures, companies which have been active in the same market for a longer period, or share the same basic opinions about their business. It is my believe therefore, that a joint venture (especially with a company from central or eastern Europe) would not be effective. In addition, since a strong, long term presence in Europe is the goal, such presence can be based only on a merger which can provide the necessary control, and basis for further development. The current economic transformation provides opportunities for acquiring company stock at much lower price than elsewhere in Europe. Also, since in the case of a construction company intangible assets are those playing major role, any possible costs associated with restructuring should not be as high as for a manufacturing company. In addition, the best of the construction companies are in possession of equipment and machinery, with which international competition can be achieved.

When looking at Europe, however, we have to consider different criteria to evaluate a potential candidate for a merger, of those used in the US. We do not look for highly specialized companies with proprietary technology as in the US where the basic operations of the parent company are already established. What is of our interest are companies with large enough scope of business and a reasonable international presence which can be further exploited. On the other hand, this does not mean that specialized companies can not be found. They can, but they are often too small, and the costs associated with their acquisition and restructuring may prove to be too large in comparison to what they can offer.

#### **ORGANIZATIONAL STRUCTURE AND COMMUNICATIONS:**

Prior to an acquisition, an organizational structure would have to be agreed, that satisfies both partners.

The new company would therefore, be composed of the parent based in the US, and its subsidiary based in Europe. Initially, the European operations would be subordinate to the parent company. After a possible acquisition, the financial statements of an European company, would be consolidated to the statements of the parent. The European office would have its CFO, COO, Marketing and Public Relations Officer, Director of Administration and Personnel and General Counselor, all of whom would report to the CEO, and their counterparts in the US. The subsidiary's CFO should be an expatriate person, appointed by the sponsor of the acquisition. Except for his usual duties, he should also perform duties of a regional CEO. The other four officers could be local, but would have to be acquainted with American business practices. The best solution would probably be to have somebody working with the CFO who would have extensive experience of both the "western" and the "eastern" cultures, and could therefore prevent any possible problems.

As the European subsidiary would grow, and assume more independence, the reporting and communications infrastructure would have to change. A regional CEO Europe would have to be appointed, reporting directly to the CEO in the US, and to the Board of Directors. The European office would cease being a subsidiary, and its officers would have equal power with those in the US. Therefore, the international responsibilities, and the conducting of international assignments would have to be assumed not by the parent's officers but by a group of officers under the direction of the President of the parent's company International division. Their primary responsibility would be to identify and take advantage of possible synergies on an international basis between the two primary parts of the company. The subsidiary would be organized similarly to the parent company. Thus, its more important part (operations) would be organized in four groups; Infrastructure, Energy, Environment, and Industry. In addition, as the subsidiary will probably not have a developed Construction management division, this would have to be established and led by expatriate personnel.

#### **INVESTMENT PROPOSITION:**

In addition to the low cost and technical expertise, companies from the Czech Republic meet the three aspects set above. They have access to the eastern Europe and CIS, have been active in the Middle East and penetrate more and more to the EC market (with which an Association Treaty has been signed). The

Czech Republic is politically and economically stable with very good management-labor relations and skilled labor force. There are no restrictions on repatriation of capital, remittance of dividends, profits, interest and principal on foreign loans, remittance of royalties and fees. The country has signed double taxation treaties with about 30 industrial countries including the US (October 1993). Even though the capital needed for an acquisition will have to be brought from abroad, subsequent financing of projects can be done by raising capital on the domestic market, since the necessary financing can be performed (bonds issues, commercial paper, banker's acceptance, etc.). In general the government's strategy is to keep the economy as liberal as possible without any trade or investment barriers, even though it does not make any distinction between foreign and domestic companies.

An example of such a company as described in the previous section is Metrostav from the Czech Republic.

As the parent is strong in Infrastructure, Energy, Industrial buildings, and Environment, Metrostav is within the line of business conducted by the parent. In particular, it is a company with strong expertise in Infrastructure and Power plant construction. Even as soon as 1980, 68% of its construction activity was underground, in accordance with the financial and ecological parameters that started to influence the industry. It is also in a possession of a new tunnel cutting technology, developed in Germany.

Its strategic plan is to become by the year 2000 the largest Czech construction company, able to deliver quality within the pre-specified time and budget. Over the next two years the plan is to grow by 20% with increasing productivity and a decreasing number of employees.

The company does not offer any special proprietary technology, since it is a general construction company. Nevertheless, it offers a strong expertise in underground construction and technical know-how, especially in new methods of tunnel cutting which can strengthen the present assets of the parent. In addition it is present in various international markets as Germany, Turkey and Cyprus.

The geographic diversification which Metrostav provides should be a plus for the parent company, mainly in the long term, since it can provide it with the different business cycles of Europe and Middle East.

Metrostav Inc. is a company which has been constructing over the past 25 years the Prague subway

network. During the last two years, its public sector contracts fell from 80% of total to 45%. The company started diversifying from its core competence due to the decreased construction activity and increased competition. Except for nuclear energy plants, water resources, and communications, where it possesses experience, it started diversifying into commercial buildings, industrial plants, and reconstructions. Some of its business may be, however, regarded as less successful, since they are not in line with its core competence. An example is the company's intention to enter the capital markets (where it has no experience at all) or its involvement in very small construction projects (which could be, however, regarded as an attempt not to lose its employees).

The company's operating structure after its restructuring consists of eight divisions. Two divisions are concentrated on Prague's subway construction and could be regarded as a separate company, since for the past 20 years they are employed on this single government contract. The third division concentrates on Marketing, Project design and Project Management. The fourth on Underground construction, the sixth on Water Resources, seventh and eighth on Services, and the eighth on Building construction and Reconstructions.

The first impression of such an organization is that the groups are very loosely defined, they are too many, and a large overhead must be incurred. Thus, even though the number of employees decreased from 5200 in 1990 to 4400 in 1991, during that year the salaries were 22% of total revenues. Nevertheless, the number decreased to 13% in 1992, due to increased revenues and decreased number of employees (increased productivity). Profit after tax is 2.1% of revenue in 1991 and 2.7% in 1992. The tax paid in 1990 was much higher than the 45% required from 1991, and therefore the numbers for 1990 should not be regarded as representative. From this rough assessment can be seen that the company is economically healthy, even though there seems to be still enough space for expense reduction primarily in the area of fixed costs. High fixed costs are, however, characteristic for almost any recently privatized, or under privatization company in the whole central Europe. Numbers indicating Metrostav's performance are shown in Table 30.

Even though 90% of Metrostav's activities are in Prague, and only 4% of the total volume are international contracts (Germany, Turkey and Cyprus), this proportion is expected to increase (overall

	1990	1991	1992
Assets	40.25	45.00	45.50
Backlog	9.65	2.50	2.85
Revenue	52.00	63.00	70.30
Expenses	45.50	58.60	65.20
NIBT	5.40	3.00	4.60
Net Income	1.80	1.40	2.60
Owners Equity	14.90	17.80	22.00
Liabilities	25.30	27.10	23.40

**TABLE 30. Metrostav's performance in \$mil. (EKONOM 36/1993).**

revenues from foreign operations increased by 100% in 1992 for the Czech construction companies).

During the privatization process 40% of shares were reserved for a foreign investor, 0.15% for employees, 3% for restitution expenses (this amount is the same for any company) and 46.85% for domestic investors.

The merger sponsor should be the Infrastructure and Energy group of the parent company, since between these two and Metrostav the largest synergies exist. Initially, as only 40% are available for a foreign investor, the bid should not exceed \$10mil. (estimating OE at \$20 mil.). However the amount may increase as CS First Boston was assigned with the task to find the appropriate foreign investor, and seven international companies showed an interest in the 40% equity share. Thus, competition may drive the bidding price higher. Later on, it should be possible to acquire additional shares, and to control over 50%. This can be done by negotiating with the various Investment Funds that possess ownership and experience sever cash shortages.

The risks associated with such an acquisition are, however, not negligible. The company restructuring must be done quickly, and consequently enable an early and successful entry of the international markets at a larger scale. During restructuring, the company may engage in the various domestic infrastructure and energy projects, partially financed and guaranteed by the government. This period must be as short as possible, in order the company to take advantage of the lower costs and subsequently establish itself on the international markets as a low cost - high quality (both from the engineering and management point of view) company. Once the company is fully under control of the new management team, it can bid for large international projects.

In order to limit the possible risks associated with the restructuring, future cash flows have to be estimated as accurately as possible, disturbances in the company performance has to be assessed, and the restructuring costs determined. Even though these seems to be the largest problems, associate with an acquisition, the reality is different. As management-employees relationships have not been so far adverse, restructuring problems can be easily overcome. Much more difficult is to cope with various legal problems, created by the new structure which has not yet been adequately tested and amended. However, an investor who is able and willing to overcome the legislative difficulties created by the transformation process, will be subsequently rewarded with market access (both east and west) and a strong, competitive company.

## ***Part 5.***

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### **CONCLUSIONS:**

The Czech Republic (and perhaps any of the central European countries) should not be looked upon from the viewpoint of low costs, either these are production costs or acquisition costs. As has been shown, the country is overcoming the transformation difficulties without any major problems. What a potential investor should examine -in addition to the economic situation- are some of the more "hidden" values of each country, which can bring the desired competitive advantage. Which are therefore the core benefits the Czech Republic has to offer? Certainly not the time limited low production costs, which even though will not reach in the near future the German levels, can not be regarded as a long term advantage. The core benefits could be divided into four general categories: Historical, Geographical, Societal and Economical.

Historically, the Czech Lands have always been more a part of western, rather than eastern Europe. In comparison with Hungary and Poland, the Czech Lands have always been predominantly an industrial, rather than agricultural country. The trade before the Second World War was oriented more towards west than east, and the industrial structure was based on the pre-war principles of manufacturing (smaller companies producing larger variety of customized products). Shortly, before the World War II, the Czech Lands were as developed as Germany. After the war, the country had a huge benefit over all the industrialized countries in Europe, since it was the only country with developed industry that was not destroyed during the war.

Even though during the past 40 years the economy was reoriented towards mass production, the old small scale infrastructure (even though in bad shape) still prevails. There are large, mass production oriented industrial companies (Holdings), but even that case, the large majority of them are composed of smaller subsidiaries, of what once were independent production units. This is in contrast to other central and east European nations, where the industry had to be redeveloped after the World War II, and was therefore adjusted to the than needs and perceptions of production. Thus, the huge companies which were developed elsewhere (East Germany, Slovakia, Hungary), face difficulties with their restructuralization, hampered by their size and



structure. The smaller scale is especially important today, with the reorientation from the mass to flexible manufacturing, that asks for a different type of plants, where not the scale but the ability to coordinate and configure different activities plays the major role. One could ask, why the whole structure has not been changed during the past 40 years? The answer is simple. First the pre-war Czechoslovak economy had been too much successful, and therefore any changes would be unjustified. Second, the after 1948 regime correctly understood that since the industry has survived the war without any damages (in comparison to Germany), it would be capable to function properly in the years to come. During those years, companies were producing output, but a very small amount of the capital generated was re-invested. Therefore, the today's results are, that on the one hand, often companies are using aged machinery and processes unable to compete internationally on other basis than cost, on the other, the pre-war industrial structure is preserved. Having to deal -in reality- with smaller scale companies, suggests that the effort and the costs of restructuring them are much smaller.

Geographically the country is the gate between the west and the east. It should not be viewed, as a potential market since its size is too small, but rather as a production platform from which both the west and the east can be easily reached. Even nowadays, most of the goods which are traded between eastern and western Europe, are transported through the Czech Republic. The lower production costs can be regarded as an initial advantage, nevertheless not a major one. Lower costs can be regarded as one of the attributes which can help a company to establish itself on the domestic market, and to penetrate more easily the international market. Central Europe is not east Asia where everything had to start from scratch, the knowledge is there but the means are missing. Only when the means are provided can the real potential be shown. And the potential of the central Europe in general, and especially that of the Czech Republic is the education and skills of its people.

Societally, due to the country's industrial character and its past relation with the west, the behavior of its people can be much more easily adjusted to the needs of a market society. This is not to suggest that the Czechs possess a superior mentality than the other central European nations of the former East Block, but to indicate, that the similar behavior which can be found among the central European nations developed during the past 40 years, and is not therefore, an

internal part of their cultures. As a result of this external image, foreign investors and especially those from the US, tend to look upon central and eastern Europe as if it was a single country with the same problems. As already mentioned, the Czech Republic has always possessed a large pool of engineering skills, and a disciplined and educated work force due to the industrial character of the country. This, in connection with the western ties the country had, have developed certain behavioral attitude of the nation which has been suppressed only by the past 40 years. The implication is therefore, that it is more easy to deal with the Czech work force, than with a work force of other central European nations. A proof of this implication can be seen in the complete absence of any strikes or social unrest during the past few years, that were marked by a deep decrease in living standards. This is very important, since before 1989 the country had the highest living standards of all the East Block countries.

Economically, the country is showing a balanced development in all the important parameters. The government's policy is not to position some economic attributes against others, as has been the case in Poland and Hungary. It succeeded therefore to create a stable environment in all the important aspects, something that is viewed positively by foreign investors. As a result of this stable policy and after the large decrease in 1990-91, the GDP is incrementally growing. The temporary decreases that could be observed during 1992, and at the beginning of 1993 were connected to unfavorable internal and external parameters. However, the Czech economy has been able so far to overcome those problems, and show a small growth in 1993.

Another important fact, is that the economic indicators (positive or negative), should not be considered as a basis on which an investment decision would be based. One should rather look beyond the numbers, on the facts that caused them and that will be influencing economic developments for much more than just one year. Economic indicators can be looked upon in relation to the performances of other central European countries, but should not be considered as subjective characteristics. This can be seen in the inconsistency between the positive numbers for the state budget, the low unemployment, and the declining industrial output. Even though such a development can be attributed to increased consumer spending which maintains government revenues and creates jobs, this assumption is in our case inconsistent. The reason is, that even though wages are increasing, the real

increases are not so high to support a large increase in consumption. The low unemployment, on the other hand, is influenced not by increased consumption, but rather, by the chronic lack of labor, given the creation of new employment opportunities both domestically and abroad. Therefore, given the balanced economic development followed by the government, a small but continuous growth, rather than violent ups and downs should be regarded as more probable in the case of industrial output and the GDP.

Inflation for the 1994 is predicted below 10%, and at the pace it is declining it could probably soon reach European standards. Nevertheless, there is still room for one time increases in prices (e.g. energy prices), which would than be followed by one time increase in inflation. Unemployment is expected to rise slightly, not so much due to bankruptcies, but rather due to reductions in personnel in companies targeting productivity improvements.

Fiscal policy is sound, with the state budget for 1994 balanced at Kc 382 bil. (with the army receiving Kc 27 bil., education 42 bil., social welfare and unemployment 139 bil.). The loss of one billion crowns due to lower taxes will be beveled off by the envisaged increase in custom proceeds during 1994.

With the slowly decreasing inflation, the increasing rate of savings, the increasing foreign reserves, and the small government surplus, capitalization of the economy is slowly improving. This can be seen in the monetary policy which transferred itself from restrictive in 1992 to "cautious" in 1993, allowing increased government spending. Thus, the liquidity problems, and the consequent high cost of capital are expected to show improvements.

The production in both the manufacturing and construction is nevertheless still decreasing (-4%, and -2%). This has as a result a decreased GDP (by 2%) to around 1%. Nevertheless, this development has to be considered as normal, since the Czech Economy has always been (due to its small size) export oriented. The economic slowdown in EC, therefore, the loss of the eastern markets, and recently a gradual loss of the Slovak market have had a negative impact on exports. The second largest parameter which influenced the decreased productivity is the uncompleted privatization.

Despite the difficulties in exports, in 1993 the trade balance will be slightly positive, due to increased exports and penetration to new markets. In addition, 50% of the GDP will be generated from exports. The

Current account with \$1 bil proceeds from tourism in 1993 (36% increase), is also expected to end the 1993 positive.

Even though domestic companies complain about the still uncertain economic environment, low demand, and financial problems, this should not be the case for international companies. Even though international companies operate under the same conditions, they enjoy some benefits over their domestic partners. First, due to their good credit ratings, they are able to obtain financing under much more favorable terms. Second, foreign companies are mostly export oriented, and therefore, the lower domestic demand (caused partially by large imports) should not be a major obstacle to their operations. Finally, the economic environment is certainly unstable for those companies who have financial problems, and are unable to adjust themselves to the new environment. Relatively speaking, any free market in comparison to planned economy will always be uncertain. Nevertheless, as the share of private sector in the economy reached 45% in 1993, the opinion of domestic companies about the economy should gradually change, with more companies being led by new managements.

The above results and predictions indicate that some time is still needed for the transformation to be completed. This would also suggest that foreign investors can expect only long term benefits. However, construction companies and especially construction materials companies offer not only long term, but also short term prospects of investment. This is not the case with the manufacturing sector which requires large capital investments, and different operational structure. In addition to management, the rest of the Czech industry needs technology as well. This is not so important in construction, where the technology used changes slowly, is relatively simple, and where professional skills play the major role. The amount of FDI targeting the construction materials industry suggest that these characteristics are well understood.

Foreign investor can invest either through the Stock Exchange, which means that there will be a large number of listed companies, since only listed companies would offer a secure investment. The second option is to negotiate with a potential company and invest directly. This option would mean, that a company does not have to meet the listing requirements, but the investor has to examine the potential investment target himself. In either case, however, the Czech company has to disclose its

financial results and show that it offers a long term perspective. This might be difficult, partly because managements often look upon a potential investor as a person who will deprive them from the company control. Another obstacle might arise if an Annual Report is requested. In 1993 many companies have not yet prepared any Annual Reports, and in the case they have, it is many times viewed as a secret information. Many Czech companies have yet to understand that no foreign partner will be interested in them, unless they provide sufficient information about themselves, and market themselves with simple means as Annual Reports. Thus the behavior of the "old times" management is responsible for many unsuccessful joint ventures. Domestic companies are, however, not the only ones to be blamed. Numerous joint ventures collapsed not only because the domestic management failed to understand the western business environment, but also because foreign investors regarded the country only as a low cost production platform, and an easy entry to the eastern Europe. Had more of them viewed it as a production base form which well engineered products with a competitive price can reach the rest of Europe, a more promising cooperation would be established.

As many companies will not be able to meet the listing requirements in the near future, foreign investors interested in a long term investment will have to commit himself to a more rigorous examination of a company financial results. This is, however, not true for an institutional investor seeking to capitalize on the Stock Exchange. Even though during the early days of trading the offer exceeded the demand, this is not the case anymore. As things settle down, privatization is proving to be successful, and new management teams started the real restructuralization, the interest in companies is changing. As predicted, after the initial decline in prices caused by the large offer, towards the end of 1993 demand excess increased the prices of the most prestigious companies. As many changes remain to be made in the industrial sector, the Stock Exchange offers large opportunities for profit.

It can be seen therefore, that the Czech economy in 1993 is at much better position than that of the other central European countries. This is the reason why the country is able to receive better investment ratings from various international institutions, which result in further improvements of the economy. It also indicates that investment in more engineering and technology intensive production is more profitable and preferable in the Czech Republic than in other countries of central

Europe. The ability of the country to adjust itself to the new rules, and to reorient its exports (its most significant economic parameter), shows that there are significant short term benefits to be exploited. Those foreign investors therefore, who followed a pro-active rather than a reactive strategy, and chose to be present in the Czech Republic during the first years of the privatization process, will benefit much more from future developments. They will be the ones who will have created the necessary basis (either it is products, processes, relations, information, channels, etc.), to take advantage of, when western Europe will have overcome its difficulties, and eastern Europe can be really considered as a consumer market.

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