Boosting the Czech Republic in the world economy

Earl L. Wright, Gail Schoettler

On the recent Forum trip to Central Europe, Forum members and guests met with Robert Hejzak, director of the marketing division of CzechInvest, the Czech Republic’s economic development agency. Article information from Earl L. Wright and Gail Schoettler. Wright is president/CEO of AMG Guaranty Trust, NA.; Schoettler is a former lieutenant governor of Colorado and US ambassador.

The race is on in Central and Eastern European countries to attract foreign direct investment, the make-break factor in their developing post-Communist economies. All these countries have pluses and minuses that have to be weighed by would-be investors.

In the Czech Republic, social costs, relatively high taxes, and a restrictive banking system are seen as negatives. On the other hand, this landlocked country has some things going for it that many investors find appealing: a highly-skilled workforce, wages that are well-below that of neighboring Germany, and a strategic location which makes it cost-effective for transshipping operations. These are some of the positives that CzechInvest promotes as it seeks to position the CR in the world economy.

Enormous challenges

The transition from the Communist system of centralized planning to a free enterprise system, largely untested in this region, has opened up a wide gap between older and younger workers. On one end of the gap is the up-and-coming generation which is faced with making the free enterprise system work against a backdrop of job and pension uncertainty. On the other end of the gap is the retiring generation which under the Communist system had been totally provided for and which now must depend on younger workers to fund their retirement through more work and more taxes.

“It is a transition that, unfortunately, does not bode well for the country itself,” says Wright.

Meanwhile, Czech companies are struggling to understand this newfangled concept called “competition” so they can take advantage of free enterprise and grow globally. However, they first must grow locally and this is difficult given the fact that there are no capital markets other than what the banks provide, and the banks are not in the business of lending to Czech business people.

The banking system is dominated by foreigners. Of the three major banks in the country, one has Swiss-French roots, one is from Austria and one is local. The consumer is burdened with exceptionally high banking fees, from the cost of transfers to ATM fees.

Lacking a capital market, there is no place for people to invest their money except in banks, which pay relatively low interest rates.

CzechInvest works on an annual budget of US$6 million, which must be stretched to include incentives for incoming businesses and support services to keep existing businesses healthy.

Relative to its goals, “The Czech Republic is undercapitalized,” says Schoettler, which makes foreign direct investment essential to the economy’s growth.

Foreign direct investment

The Czech Republic has been more successful than the rest of the former communist countries in attracting FDI, says Schoettler, “due mainly to the low wages of both skilled and unskilled labor.” In
Boosting the Czech Republic in the world economy

*Earl L. Wright, Gail Schoettler*

Germany, unskilled manufacturing labor costs are US $19,000 per worker per year. In the US, the cost is $18,000, in Poland it's $6,300 and in the Czech Republic it's US $3,700. Only in Hungary and Slovakia are wages lower than the CR, $3,000 and $2,100 respectively.

In other comparisons, CzechInvest claims that FDI per capita is $3,603 in the CR, whereas it is $2,754 in Slovenia, the second best performer of the Eastern European bloc. This is another way of saying that the Czech Republic receives more foreign direct investment than any of the other former Communist countries. Subsidiaries of more than 1,600 foreign manufacturing companies operate out of the CR.

FDI in 1993 was EUR 1 billion. In 2002, it was EUR 9 billion. Between 1993 and the third quarter of 2003, the Czech Republic was favored with nearly EUR 38 billion in FDI.

“Privatization accounts for about half of the FDI,” says Schoettler. Wright adds, “Without privatization, the historical level of foreign direct investment appears to be in the $3-$5 billion range for the last five years and is forecast to be in the $5-$7 billion range for the next five years.”

Germany is the No. 1 source of investment capital in the Czech Republic; Japan is No. 2.

The automotive industry gets a hefty share of FDI inflows, followed by the electronics sector. The jobs created “are engineering related but not of the high skill level you would find in the US,” says Wright.

According to a 2004 study by the management consulting firm of A.T. Kearney, the CR “possesses the best transport network in Central and Eastern Europe.” This, and its close location to Poland and Germany, gives the Czech Republic a distinct advantage in luring companies engaged in import/export trade.

Currently, the corporate tax is 30 percent versus 19 percent in Slovakia. The Value Added Tax ranges from 22 percent to 5 percent, depending on the product. Now that the Czech Republic is in the European Union, the VAT will go to the market rate to meet EU requirements. The corporate tax rate will be 24 percent in 2006.

**Educated workforce**

Twelve percent of the Czech population has a university degree. While this is better than other Eastern European bloc countries, it’s nowhere near the 60 percent in the Netherlands.

“The communist regime restricted enrollment and the Republic has been trying to reverse this situation,” says Schoettler. In 2003, the total number of students graduating from bachelor, master and doctoral programs was 34,594, up dramatically from the 18,928 in 1989.

CzechInvest emphasizes its highly educated work force comprised of college and technical school graduates, i.e., engineers. Wright notes that the skill level of the Czech workforce may be overstated; however, the manufacturing companies that are being set up suggest that the labor force is good enough to compete with the labor force of other developed European countries. Factor in low wages and high productivity and it’s easy to appreciate why an increasing number of foreign companies are relocating their production facilities to the Czech Republic.

The minimum wage in the CR is US$257 per month. The average wage is about US$520 per month. There are perks, however. Workers receive four weeks of paid vacation a year in addition to 12 national
Boosting the Czech Republic in the world economy

Earl L. Wright, Gail Schoettler

holidays. Unemployment nationally averages 10.5 percent, running as high as 25 percent in some rural areas and as low as 3 percent in Prague.

Traditionally, Czechs don't move; consequently, the workforce tends to remain fixed. A company can put up a manufacturing plant or facility in a particular area and count on that labor force to have a relatively low turnover. However, with the country's ascension to the European Union, this may change. “The EU is heading toward the same vision as the 50 US states, with free movement of people, capital and jobs,” says Schoettler. “Unlike the US, language barriers are a big difficulty, and each country has its own history, culture and religion.”

According to EU rules, there will be restrictions on the movement of labor for the next seven years. Once restrictions are lifted, the CR expects about 8.4 people per 1000 to move to other countries in search of work.

Observations

One of the economic development arguments put forth by CzechInvest is the country's low manufacturing costs. A company can set up and run a factory in the CR for approximately one-fifth of what it would cost in developed countries such as Germany or France.

“The disadvantage,” says Wright, “is that there isn’t a huge amount of additional labor force available to take advantage of these cost savings.

“An issue that was unanticipated is the influx of Albanians, Ukrainians and immigrant workers from the east who will eventually start infiltrating the Czech Republic. This in turn will cause additional social costs, which the government is not prepared to handle at the present time.”

Wright questions how long the Czech Republic and its former communist neighbors will be able to tout the advantage of cheap labor given the attendant social costs.

“It is clear that in the near term, the advantage will exist,” he says.

Where Wright sees an opportunity is for venture capitalists to invest in Czech-owned companies and bring in new management and modern management techniques. “The goal would be to produce and export goods unique to the Czech Republic utilizing the skill sets that have been developed by certain labor forces such as at the Bohemian Glassworks Factory.

“But this is a relatively small opportunity,” Wright adds. “Bohemian Glassworks, even though it produces a worldwide product, is only a $22 million-a-year company. It appears there may be other companies around the Czech Republic like Bohemian Glassworks, but not of a huge magnitude.”

Unresolved social issues are looming on the horizon, says Schoettler. “Under communism, people were taken care of by the state. Today, they must learn to take care of themselves.”

The pension system, which is supported through taxes, is in a state of confusion. “There must be reform because the current pension system is unsustainable,” says Schoettler. “The country is working on pension reform and there are many proposals on the table, from a public-based and guaranteed system to one where each person would take care of himself or herself, saving personally for retirement. But it is proving very difficult to get a consensus on any particular program.”
The problem may lie in the makeup of the legislative body, says Wright.

“In the Czech Republic there is no clear majority in the legislature. Approximately 13 percent of legislators are in the Communist party with the balance split between conservatives and liberals. Thus, the Communist party has a lot to say regarding which laws will or will not be passed.

“I don’t imagine this would bode well for the controlling of social costs.”

**Czech Republic Vital Signs**

- Capital: Prague
- Population: 10.3 million
- Population growth rate: -0.05% (03)
- Labor force: 5.3 million
- Unemployment rate: 10.5% (03)
- Language: Czech
- Literacy: 99.9%