WP - 58

CZECH & SLOVAK REPUBLICS: BUSINESS OPPORTUNITY OR ILLUSION?

by

Dr. S. Raghunath & Dr. J. Ramachandran*

February, 1994

INDIAN INSTITUTE OF MANAGEMENT
BANGALORE

*Assistant Professors, Indian Institute of Management
Bangalore

CZECH & SLOVAK REPUBLICS: BUSINESS OPPORTUNITY OR ILLUSION?

by

DR. S. RAGHUNATH AND DR. J. RAMACHANDRAN

ABSTRACT

This paper explores the opportunities afforded by the Czech and Slovak Republics from the perspective of foreign enterprises regardless of the home country base of these enterprises. It does not evaluate the merits of the policy changes initiated in these nations.

Using a business opportunity evaluation framework. the paper recommends accessing business opportunities in the Republic of Czech, given the current reforms enhancing its receptiveness to foreign investment and its vast experience in trading with Eastern European countries especially in iron and steel, metals and chemicals.

The authors observe that the combination of the urge to join the European community, study market oriented pressure from bodies like the International Monitory Fund and courageous leadership of the democratic government may ensure that at least the Republic of Czech if not Slovak continues market oriented reforms, instead of reneging into greater government interventions. Therefore it is important for foreign investors to enter sooner than later into the Republic of Czech, the reason being that it takes time to build knowledge of how to do business in this market and to build contacts and networth. The companies intending to build their own image and awareness when the markets are still developing, will benefit at the expense of companies which come later to the market.

INTRODUCTION

In a rapidly evolving borderless world, foreign enterprises would invest in a certain nation only if they expect a globally competitive return on investment. They would evaluate the opportunities in almost all corners of the world today before making a choice. In their evaluations they would not restrict themselves to the policies of a specific nation but also compare them with those of other nations before deciding on investing in a specific nation. Further, their emphasis on the return on their investment takes their decision making beyond the traditional concerns like whether the nation provides a credible framework of institutions, laws and regulations that define individual rights and assure that legal claims can be enforced and liability rules applied. In today's world these are necessary conditions and not sufficient conditions.

The key requirement today is whether investment in a specific nation provides these enterprises with a competitive advantage - either in the form of access to the domestic markets or lower wage costs or access to raw materials or specialised manpower skills or locational advantages including an advantage like membership of a trading bloc like the European community, etc. This is because the forces of competition are not confined to the nations competing for resources - the enterprises too confront severe competition in the current business environment.

This paper explores the opportunities afforded by the Czech and Slovak Republics from the perspective of foreign enterprises - regardless of the home country base of these enterprises. It does not evaluate the merits of the policy changes initiated in these East European states.

Changes in Enterprise Response Behaviour :

The opportunities to invest in virtually every part of the world today has resulted in highlighting to the top managements of firms, the need to do away with their old approach to international investments.

In the past, firms have tended to be excessively influenced by dramatic events. A student riot, a political disturbance, etc., would affect their decision making. It was found that the top managements of these firms, in their approach to overseas investments were subject to the 'odd lot syndrome' (Rummel and Heenan, 1978). The odd lot syndrome, so named because of the tendency of the odd lot investors to exhibit such behaviours, lead to the top managements to be ' overly influenced by periodic swells of optimism or pessimism "(Rummel and Heenan, 1978). It is increasingly being realised that business decisions that are based on subjective first impressions could lead to faulty international policy.

Further, in the past it has been observed that firms tended to follow gradualism in their approach to international investments. Their internationalisation process has been well researched and has been found to follow what has come to be known as the 'Uppsala internationalisation model.' In this model, the internationalisation of the firm, which has its theoretical base in the behavioural theory of the firm (Cyert and March,1963; Aharoni,1966) and Penrose's (1959) theory of the growth of the firm, is seen as a process in which the enterprise gradually increases its international involvement. This process involves an interplay between the development of knowledge about foreign markets and operations on one hand and an increasing commitment of resources to foreign markets on the other'(Johansson and Vahine, 1977).

It is increasingly being realised that such a strategy could lead to firms missing out on potentially attractive markets. This perception has largely been influenced by the staggering successes achieved by firms from East Asia, especially Japan. In the rapidly changing business world of today, where the only certainty is uncertainty, speed of response is equally crucial for achieving strategic success. Thus a strategy of gradualism is unlikely to yield rich dividends. 'The global competitive battles of the 1980s were won by companies that could achieve cost and quality advantages in existing, well defined markets. In the 1990s, these battles will be won by companies that can build and dominate fundamentally new markets' (Hamel and Prahalad,1991).

This need for achieving significant presence in fundamentally new markets - and the attendant changes in the mind set which it requires (for example, greater risk taking) - by enterprises augurs well for the East European nations like the Czech and Slovak Republics which are making efforts to open their economies and integrate with the global economy.

Opportunity Evaluation Framework:

Enterprise evaluation of opportunities for foreign investment can be broadly classified into two components: (a) Evaluation of political risk and (b) Evaluation of business risk.

Political Risk:

The principal parameter which would be evaluated by enterprises in the current context would be the issues of stability of the new political system, particularly the stability of the Government in power which has initiated the reforms. This is also primarily assessed to ensure that the changes ushered in, the economic reforms, would be sustained and the chances of a volte face in future are minimised if not eliminated. In an otherwise highly turbulent world, enterprises would seek to invest in nations which, even if they do not contribute to a reduction in the turbulence they confront, would at least not compound it by adopting an inconsistent policy framework. Thus firms would evaluate the likelihood of consistency in the policy framework adopted by the countries. This parameter is of crucial importance for any enterprise planning to invest in a foreign nation.

Other issues that would go towards evaluation of the political risk are issues like risk of expropriation of investments, profit transfer/repatriation rights, approval procedures, degree of discrimination/ preference for domestic companies vis-a-vis the international companies in the policies adopted by the nation (essentially whether it is a level playing field) etc.

Business Risk:

Business risk is a function of the opportunities available in the country and the conditions which prevail in the country which afford the foreign enterprise to leverage its capabilities, so as to gain a competitive advantage in the global/domestic market place. Since the capabilities are firm specific in a generalised framework, the focus would be on the condition which prevail, including the policy framework.

Broadly the factors that are evaluated can be classified into:

Macro economic factors like the size of the national income, per capita income levels, the income distribution, balance of payments position, the currency exchange rate, inflation, employment levels etc;

Commercial factors like import regulations, interest rates, labour costs including the labour laws prevailing, exit policies, etc;

Market factors including the size of the market, degree of competition including industry structures, market structures including the communication channels, capabilities/degree of expertise both commercial and technical, of local firms, etc; and

Infrastructure factors like availability of Power, Telecommunication facilities, Transportation facilities like Rail, Road, Ports and other transportation facilities.

In the following sections, the above framework has been employed to evaluate the business opportunities in the Republics of Czech and Slovak.

CZECH AND SLOVAK REPUBLICS

Czechoslovakia which came into existence as a separate state in 1918 after the collapse of the Hapsburg Empire faded into history on 1st January 1993. It was replaced by independent Czech and Slovak Republics. After the collapse of the erstwhile communist regime, the peoples of Czech and Slovak opted for independence and the Czech and Slovak Republics came into being. The separation has been bloodless and far less traumatic than the experience of the other Warsaw Pact countries including the erstwhile Soviet Union.

The two new countries of ten million Czechs and five million Slovaks came into existence after seven months of negotiations between the Czech Prime Minister Vaclav Klaus and his Slovak counterpart Vladimir Meciar. Klaus is a free market champion and Meciar is a former Communist. The two new nations will remain linked in a customs union and initially maintain the Czechoslovak Crown as the common currency. Before the breakup of the Federation, free market champion Klaus, rebuffed proposals by Meciar for a slower pace of economic reform. Eastern European experts forecast economic problems in the short term, with rising unemployment, higher inflation, lower productivity and lower standards of living. In the long term, it is predicted that the Czech Republic freed of the burden of subsidising Slovakia will begin to surge ahead.

Any foreign enterprise which is evaluating business opportunities in the Czech and Slovak Republics would consider, as stated earlier, at the first level of evaluation, the two components - the political risk and the business risk of entering these countries. The political risk could be assessed along the following criteria.

Likelihood of Consistency in the Policy Framework

This would be the primary criterion which would often be employed for evaluating business opportunities in any country. However, given the separation of the erstwhile unified country into two separate Republics, enterprises would assess the sustainability of these two nations as independent Republics. Businesses would assign a greater risk factor to opportunities available to these two countries.

After considering the sustainability, enterprises would evaluate the policy frameworks as well as the policies enunciated by these two nations and constantly monitor them for assessing consistency.

Prima facie, since the strategy for opening the economy to market forces, was initiated by the present Czech leaders, it can be speculated that market oriented policy measures will continue to be pursued. The same cannot be asserted for the Republic of Slovak, since its present leadership has its strong roots in the communist ideology, notwithstanding its efforts to 'democratise' Slovak. The Movement for Democratic Slovak being the political party commanding a political majority, it is quite likely that the liberalisation measures initiated before the split may slow down. This apart from the fact that Slovak is economically backward when compared to the Czech nation.

It would also be relevant to review some of the factors that affect foreign investment such as approval procedures, profit transfer rights, tax exemptions, remission of import duties and protection of foreign investment, etc. These factors have been analysed in the context of the Czech Republic as the information available pertains to the reforms brought about by the Czech Government.

Approval Pocedures

A licensed approval is required for enterprises in the banking sector and in sectors important for ensuring the defense and security of the state. When a foreign enterprise is to be established with a state enterprise, the enterprise must have the approval of the privatisation project from the appropriate ministry, the Czech State Bank or through an exemption from the government.

The basic steps required to establish a foreign participation enterprise are as follows:

* The enterprise must acquire a foundation license (in the banking sector), a decision approving the privatisation project (in joint ventures with state enterprises).

* Enterprises wishing to engage in foreign trade must obtain an additional license for foreign trade and must be enrolled in the company register.

* Foreign participation may be funded without approval of the federal ministry of finance :

    + if the enterprise in question is being founded or its business is being undertaken by a foreign participant;

    + apart from a foreign participant, the Czech partner is a natural person or a Czech commercial company; or

    + the Czech partner is a cooperative founded after July 1, 1988.

Profit Transfer Rights

The entire profit can be changed to hard currency and taken out of the country with no limitations.

Tax Exemptions

The corporate tax rate for domestic enterprises is 55%. When the taxable income does not exceed CSK 2,00,000; the enterprise with foreign equity participation pays 20% tax. If the income is higher and the share of the foreign partner in the foundation capital is more than 30 %, the tax rate is 40% on taxable income over the basic CSK 2,00,000. However, if the foreign partner's share is less than 30% of the capital, the enterprise pays 55% tax on the taxable income over the basic CSK 2,00,000.

Remission of Import Duties

The average custom duty is 4.5% and the material investments are subject to import duty and the amendment to the customs act enables these investments, or other import of goods to be exempted when the company concerned applies for the establishment of free custom zones. Goods may be imported into the free custom zone without depositing custom duty. This is available only to those enterprises possessing a license for foreign trade activities.

Differentiation Between Domestic Manufacture and Imports

There is a surcharge on imported consumer goods and food products. It is paid together with the import duty. The current surcharge is 15% on the value of the goods imported.

Protection of Investments

Investments are protected against expropriation in three ways: by the Constitution, the Act on Enterprises with foreign property participation and Bilateral Agreements dealing with the promotion and protection of investments.

Apart from the political risk, enterprises would assess the business risk of operating in Czech and Slovak Republics. Typically, business risk would be assessed by looking at :

a. the capabilities/expertise of local enterprises
b. international competition
c. infrastructure - telecom, transport, and power
d. market structures
   pricing
   distribution system
   communication vehicles - press, audio (radio), audio visual (television).
e. industry structures
f. learning time

Lack of adequate reliable information renders speculating (assessing) on the nature of business risk, in these two nations, meaningless. Consequently such an exercise has not been made. This highlights an important need. Policy makers, instrumental in opening their economies to foreign enterprises need to focus not only on legislation which affects the control dimension but also need to initiate and support the development of suitable data base to address the enterprise concerns on the political and business risks involved, in entering the market of that country. In the absence or in the face of inadequate information on micro level concerns enterprises find it difficult to assess the risks and hence audit the opportunities in countries opening their economies to foreign participation.

It is important to highlight here that enterprises arrive at their decision to enter a particular country not merely on the absolute measure of the risks discussed above but would also do a comparative analysis of risks across target countries in a region.

A caveat would be appropriate here. Past information could be misleading, especially for the former socialist bloc, because their operations were governed more by political ideology than hard economic rationale.

For example, the United Nations Industrial Statistics, 1987, shows that Czechs achieve very high productivity in iron and steels (1.5 against an industrial average of 1). This gives an idea as to where the Czech's competitive strengths used to lie. But this data apparently is not valid any more because of technological developments and the failure on the part of the Czech firms to modernise. Thus any decision taken on the basis of this past information could come unstuck.

The policy makers in these transforming economies need to pay urgent attention to this need. In today's competitive world, making available the right type/kind and quantity of information ensures that half the battle is won.

Having said that, the onus does not rest with the policy maker alone. Enterprises too need to match their and their country's competitive advantages to be successful in the transforming economies. Based on the limited information available, we believe, that these two republics offer excellent opportunities to those enterpises which possess strong technological capabilitites.

Foreign investors need to assess the difference which a technology transfer can make to a Czech organisation - which activities can it affect and what value will that add. Computers, telecommunications, machine tools, electronic process control, packaging and processing equipments, and environmental pollution control equipments are all crucial to the economic development of Czech and Slovak Republics and so will be important collaboration proposals in the short term.

In the field of information technology, the markets for hardware, peripherals, microprocessors, circuits including disks, printers and monitors as also systems and application software are also growing. As value addition can be achieved by Indians at a lower cost, our VARs will be more competitive than those from Europe and the US.

Having done this level of analysis, an enterprise may then consider entering a market through one of the several modes of entry such as through exporting, opening a sales subsidiary, licensing, joint ventures and sole ventures.

The entry mode has to be chosen depending on the reasons for going into Czech and Slovak Republics. The entry strategy depends upon whether the investor is targeting market share or low cost sourcing and the industry in which the investment is being made. The investor could acquire an existing company or enter into joint ventures.

Entry through Acquisition:

Time is a source of competitive advantage and as entry through acquisition is faster than other modes of entry, it allows the foreign investor to exploit this advantage. A foreign enterprise does not need approvals from the government when the enterprise is solely funded by a foreign participant or along with a Czech partner who is a natural person or a Czech commercial company.

Acquisition will also be preferable, if the pricing of the venture and the assessment of the market potential for the existing products can be arrived at with reasonable amount of accuracy. This is particularly useful when an investor is seeking market share and he finds that the retail and distribution networks are grossly underdeveloped. In such a situation the investor is likely to seek an enterprise with a distribution network or a strong local brand. For instance, Volkswagen won the international auction to buy Skoda, the Czech auto company. It has a 70% stake at a price of $6,630 million.

But then Volkswagen discovered to its dismay that it was off target in estimating the market potential for the existing product and the equity the brand name Skoda commanded in the Czech market. Today it is reportedly downsizing and pruning its operations to make the acquisition viable. The experience of Volkswagen, once again , reinforces the point made earlier that there is a great need for dissemination of micro level information.

The Czech Republic has attracted a number of overseas investors who opted for the acquisition route. Philip Morris, the American tobacco giant acquired a 100% stake in Tabak, a tobacco company at a value of $395.8 million. Mercedes Benz (Germany) has acquired a 31% stake in the Czech truck manufacturing company, Avia, at a price of DM 450 million. Nestle and BSN (Switzerland, France) have a 43% stake in Cokoladovny, a food processing company at a price of $95.5 million.

Entry through Joint Ventures

The rationale for exercising a choice in favour of joint ventures lies in the informational ineffficency that is likely to exist regarding the enterprise slated for acquisition. The joint venture route could overcome some disadvantages of an acquisition which include having to take on all or some of the Czech entity's debts and other **existing or potential** liabilities. If the perceived informational inefficiency is high, enterprise would opt for joint ventures inspite of the possibility of delay in launching operations.

Making use of the knowledge of local business community and taking advantage of local distribution channels could be some of the primary reasons for considering joint ventures. It is important to note that in a survey conducted by Business

International, a member of the Economist group of publications, investors who had experience dealing with government officials and privatisation bureaucrats considered investment negotiations a major stumbling block. This underscores the importance of a local agent/ partner. This is so because the negotiating bureaucrats have little experience of negotiating with foreign companies about investment issues. Thus almost inevitably there is a possibility of situations where negotiators would make unrealistic demands on the foreign investor, not realising the constraints under which such investors work. On the other hand some negotiators will be far too generous to foreign investors, thus triggering a popular backlash against the relevant deals.

One of the significant joint venture agreements signed in 1991 was between the automobile giant Mercedes-Benz and two Czech lorry makers AVIA-Praha, producer of different types of utility vans, and LIAZ Jablonec, manufacturing heavy duty lorries. This was for producing M-B utility vans of the M-B 100-180 (2.5-3.5 tonnes) construction series, plus lorries of the M-B 550 (3.5 - 5 tonnes) series. Initially AVIA has a 49% stake, LIAZ a 20% stake and M-B, a stake of 31% in the tripartite venture.

The basic purpose of this joint venture is to build a base for the production of heavy duty lorries able to compete on international markets. The immediate target markets are Central and Eastern Europe. M-B was attracted by the lower wage costs in the Czech Republic and the Czech partners' knowledge of East European markets, which would improve the competitiveness of the lorries. The well educated Czech labour force is available for roughly one-tenth of the German wage cost. The point to note is that the productivity of the Czech and Slovak labour force is perceived as the comparative advantage that the labour force has with reference to other Central and Eastern European economies.

It is important to audit the opportunities in Czech and Slovakia. For those products where the Czech and Slovak Republics is already competitive, and the foreign investor has little to add except capital, the opportunity could be looked upon as a low cost sourcing base for promoting exports to other countries in Europe and elsewhere. Machinery and equipment have traditionally constituted more than 50% of exports to Eastern European countries and about 22% of exports to non-socialist countries. Fuels, mineral raw materials, metals, chemicals, fertilisers and rubber have constituted more than 20% of exports to Eastern European countries and approximately 50% of the exports to non-socialist countries.

Where Czech and Slovak are currently uncompetitive and major changes are required, a purchase might be in order. Tourism is a growth industry in Czech and Slovak, given its natural beauty, its historicity and a developed infrastructure of highways, railways and waterways. In the last few years, due to the urgent need to increase hard currency revenues, collaborations for new hotel constructions have increased given the surge of tourists from West Germany, Austria, Italy, USA, France, Sweden and UK.

Typically, Czech and Slovak firms in tourism own resorts, hotels, restaurants and trade networks. Those which go up for sale or foreign collaboration need capital infusion, advanced technology and knowhow to develop and manage properties.

Finally, if there is no prospect of international competitiveness being achieved, it may be best to ignore the investment opportunity. Low income levels of the average Czech and Slovak imply lower levels of saving and purchasing power. Unless the foreign investor is able to bring in consumer products based on cost-efficiency, superior technology and greater benefits arising out of product innovations, the domestic market may not be an attractive target in the short term.

CONCLUSION

By the turn of the century, Czech and Slovak Republics along with other Eastern European countries are slated to merge with the other trading blocks, consisting of EEC and EFTA. Given the current reforms enhancing the Czech Republic's receptiveness to foreign investment and its vast experience in trading with Eastern European countries especially in iron and steel, metals and chemicals, it will become a significant part of the European economy. The combination of the urge to join the European community, steady market oriented pressure from bodies like the International Monetary Fund and courageous leadership of the democratic government may ensure that atleast the Republic of Czech if not Slovak continues market oriented reforms, instead of reneging into greater government intervention.

As Lester Thurow stated in his recent book 'Head to Head: The coming economic battle among Japan, Europe and America':

> *If one were ranking prospects for development in Middle Europe, the Czech part of Czechoslovakia would be the most likely prospect for development after East Germany. Hungary would come next, with Poland following. Slovak, Rumania, Bulgaria and Albania would be the least likely prospects.*

It is important for a foreign investor to enter sooner rather than later into the Republic of Czech , the reason being that it takes time to build up knowledge of how to do business in this market and to build contacts and networth. Companies which are intending to build brand image and awareness when the markets are still developing will benefit at the expense of companies which come later to the market.

REFERENCES

______ , (1993), Czechoslovakia splits into two states, Bangalore: The Economic Times, pp 10, January 2, 1993.

_____ , (1991), Czechoslovakia: Country Profile, London: The Economist Intelligence Unit, pp 2-28, July, 1991.

_____ , (1991), Basic Conditions for Foreign Investment in the Czechoslovak Economy, Prague: Federal Agency for Foreign Investment, pp 3-15, July, 1991.

______ , (1992), Investors in Eastern Europe Share Lessons Learned, London: Business International, pp 341-342, October 26, 1992.

Aharoni, Yair, (1966), The Foriegn Investment Decision Process, Boston: Division of Research, Graduate School of Business Admiistration, Harvard University.

Cyert, R.M. & March, J.G., (1963), A Behavioural Theory of the Firm, Englewood Cliffs, N.J: Prentice-Hall.

Hamel, Gary and Prahalad C.K.(1991), Corporate Imagination and Expeditionary Marketing, Boston: Harvard Business Review, pp 81-82, July-August 1991.

Johansson, J.K., and Jan-Erik Vahine (1977), The Internationalisation of the Firm: A Model of Knowledge Development and Increasing Foreign Commitments, Journal of International Business Studies, Spring-Summer 1977, pp 23-32.

Khanna, Vikram. R, (1992), Central Bank Governors Discuss Progress of Monetary Reform in Eastern Europe, Washington: International Monetary Fund, IMF Survey, pp 337-340, November 9, 1992.

Penrose.E.T.(1959), The Theory of the Growth of the Firm, Oxford: Basil Blackwell.

Rummel, R.J., and Heenan, David. A, (1978), How Multinationals Analyse Political Risk", Boston: Harvard Business Review, pp 67, January, 1978.

Sikorski, Radek (1993), Poland, Hungary, Czech 'n Slovak, London: The Economist, The World in 1993, pp 38-39.

Thurow, Lester. (1992), Head to Head, New York: William Morrow & Co. Inc, pp 90.

______ , World Economic Outlook (1992), Washington; International Monetary Fund.

Watson, D.P & Frazer, Scott (1991), Eastern Europe, Commercial Opportunity or Illusion?, London: Pergamon Press, Journal of Long Range Planning, pp 17-22, October, 1991.

Zieleniec, Josef, (1991), Political, Organisational and Legislative Aspects of Mass Privatisation in Czechoslovakia, Prague: Charles University, pp 1-6, December, 1991.