

# Doing Business in THE CZECH REPUBLIC

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## The economy is open but institutions are weak

The German motor is helping drive recovery although public sector corruption is a worry for investors, says Jan Cienski

The Czech Republic has returned to growth after a severe recession in 2009. But economic expansion is significantly slower than in neighbouring ex-communist countries, a sign of both the need for further reforms and of the difficulty in spurring fast growth in a country which, to all intents and purposes, is no longer an emerging economy.

From the streets of Prague, lined with boutiques and crammed with gleaming Skodas, Audis and Volkswagens, to the myriad factories supplying car parts, electronics components and other goods, largely to Germany, it is clear that the country – with a per capita gross domestic product of more than \$25,000 – has left behind its shabby past as a Soviet satellite.

In its statistical compilations, the International Monetary Fund has to take care to group the Czech Republic with “other advanced EU economies” such as Denmark, Sweden and the UK, and not with its poorer ex-communist brethren such as Poland and Romania.

“The Czechs never let us hear the end of it if we don’t do that,” grumbles an IMF official.

But the price of that progress is slower economic growth, as the old advantages of a cheap but skilled workforce have a diminishing impact.

The economy contracted by 4.1 per cent in 2009, but returned to 2.3 per cent growth in 2010. However, fiscal tightening has cut the expansion to an expected 1.9 per cent this year.

That means that economic development is going to have to come from productivity growth, research and development and entrepreneurship – things that have not been the country’s strong suit.

Although there have been some successes, such as RSJ, one of the world’s largest algorithmic traders (see page 4) and NWR, a local coal company that is trying to expand into neighbouring Poland, Czechs tend to be less entrepreneurial than Poles and Romanians, with fewer local businesses

reaching a significant size, in part due to the constraints of the small domestic market of 10m.

Central Europe as a whole labours under the bureaucratic heritage of the Russian and Austro-Hungarian empires, overlaid with the accretions of communism, but the Czechs have among the worst rankings in the region in the World Bank’s Doing Business survey, a problem that the centre-right government of Petr Necas, the prime minister, promises to tackle.

“The Czech Republic is a relatively small and open economy,” he says. “For this reason, we are far more dependent on foreign demand than, say, Poland or Germany. The only thing we can do – and are doing – in such a situation is constantly to improve the conditions for doing business in our country. We need to increase our competitiveness, especially in the area of institutions, which has been shown to be a weakness in international comparisons.”

Mr Necas is also committed to fiscal reforms and to revamping the pension and healthcare systems.

“Reforms are a condition for the current government’s existence. Without their passage, it has no reason to continue,” he says.

The governing coalition aims to bring the budget deficit to below 3 per cent of GDP by 2013, from an estimated 4.2 per cent this year and to balance the budget by 2016.

That has meant deeply unpopular pay freezes and big cuts in high-

“Without reforms, a scenario similar to states dependent on financial assistance from abroad would await us”

profile projects such as the highway construction programme – which will now be delayed by years.

In addition, the government wants to create a reformed pension system that would divert part of workers’ social security payments from the current pay-as-you-go scheme into private retirement accounts – the cost of the reform would be paid by increasing the VAT rate.

The government also wants to



Stop the government: a transport strike on June 16. Pay freezes and big cuts are causing protest

EPA

increase healthcare co-payments.

In response, labour unions have staged protests, including a transport strike last week, and the government’s poll ratings are plunging.

Mr Necas has not been helped by increasing instability in the coalition, with squabbles with the smallest member – the populist Public Affairs party – over cabinet positions. The coalition, which controls 115 seats in the 200-member lower house of parliament, survived one vote of confidence in April and faces another as it votes on further reforms.

“The coalition is not a happy group of people,” says Jiri Pehe, a Czech political scientist.

“They spend much more time attacking each other than the opposition does attacking them.”

However, the government’s unpopularity may keep it in office, as the coalition potentially faces a drubbing if it calls early elections.

Its credibility has also been dented by a series of corruption scandals, strengthening public perception that there is something rotten at the core of Czech political and business life.

“People are upset at being asked to make sacrifices and tighten their belts when millions of korunas a year disappear in suspicious public tenders,” says Mr Pehe.

Allegations of corruption are

particularly evident in the public sector, tainting arms deals and infrastructure projects.

“Corruption is the first question we get from every potential investor,” explains Weston Stacey, executive director of the American

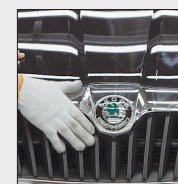
Chamber of Commerce in the Czech Republic. He says the issue is less critical in the private sector but “investors who have to deal with the public sector face a lot of problems”.

The problem has become so acute that a survey by the German-Czech

### Inside this issue

**Roma minority** Discrimination adds up to a ‘lost opportunity for the nation’ **Page 2**

**Automotive industry** A network of parts suppliers has grown up to service global carmakers **Page 2**



**Banking** A conservative approach has benefited both the nation and banks’ mainly foreign owners **Page 2**

**Tourism** The country has a wealth of cultural heritage but some think Prague needs to be more ‘trendy’ **Page 3**



**Stock exchange** The scars from botched state asset privatisation in the early 1990s remain **Page 3**

**Property** Economic recovery in Germany is driving demand for warehouse space **Page 4**

**Profile** The rise of a ‘black box’ trading company that is the largest presence on the NYSE Liffe **Page 4**

**Nuclear energy** There are three bidders to build two reactors. Some believe state guarantees are needed **Page 4**



## Rising wealth will make aid a hard case to plead

### EU funds

The current budget will almost certainly be the most generous, says Jan Cienski

Without the European Union, the Czech Republic would not be preparing to build the most powerful laser in the world.

The behemoth is part of the €700m (\$987m) Extreme Light Infrastructure project (ELI), partly located south of the Czech capital.

The laser, while not funded from the EU’s structural programme, is one of the many benefits flowing to the Czech Republic since it joined the bloc in 2004.

The most visible impact of membership is the steady improvement in the country’s highway network – about a fifth of the €26.7bn the country will receive in structural funds during the EU’s 2007-2013 budget cycle is allocated to road construction.

Sitting in his office at the Czech Road and Motorway Directorate, the government agency in charge of the transport infrastructure programme, René

Poruba, the director of the construction section, says that without EU aid, “the scope of construction would be much smaller”.

On his wall is a large map of the Czech Republic stuck with flag pins showing the existing network, as well as a grey web of proposed highways that are supposed to link up to form a modern transport infrastructure.

That future has retreated into the distance, thanks to severe cuts imposed by the government as it tries to bring the budget deficit

“We would appreciate access to at least the same level of financial support [as now]”

below 3 per cent of gross domestic product by 2013 from a high of 5.9 per cent in 2009.

“The cutbacks were a real surprise to us,” says Mr Poruba. He says the directorate’s annual budget was reduced from from about Kc60bn (\$3.5bn) to Kc35bn. Without EU funds, the effects would have been even worse.

As it is, projects that include building a highway towards Vienna, the northern ring road around Prague and a highway east to Slovakia have all been frozen.

“It’s getting worse because of the lack of money,” laments Mr Poruba.

Thanks to the EU, long-suffering residents of Frydek Mistek – a town not far from the Polish border that has thousands of cars and lorries a day driving down its main street – will obtain relief when the promised highway bypass is eventually completed.

Other projects with EU funding have also been preserved, with the budget axe being aimed at those funded solely by the government.

At a time of fiscal restraint, EU funds are also going towards developments such as upgrading sewerage plants, increasing labour market flexibility and supporting research and development.

In all, some 60,000 applications for funds have been submitted, and 10,000 projects have been completed.

“It is obvious that structural funds support the economy as a whole,” says Kamil Jankovsky, minister for regional development,



Kamil Jankovsky: ‘structural funds support economy’

who notes that the Czech Republic has used about €7bn of the funds available for the current budget cycle. The problem is that the current one will almost certainly be the most generous.

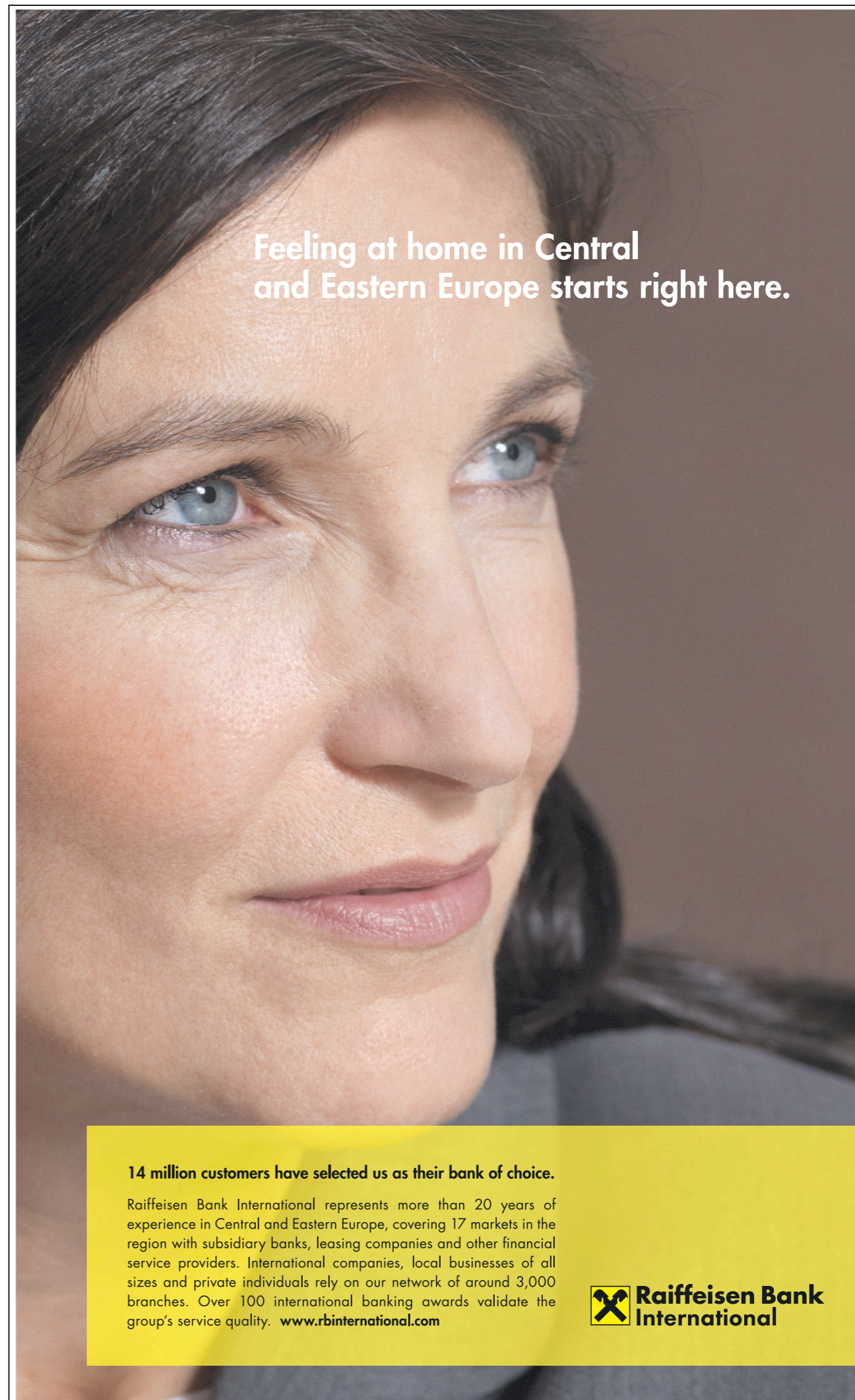
EU contributor countries have problems of their own, and it is increasingly difficult for a prosperous Czech Republic to claim poverty.

The country now has a per capita gross domestic product at purchasing power parity of more than \$25,000, and Prague is one of the EU’s wealthier cities.

“We would appreciate access to at least the same level of financial support that we are managing nowadays,” says a hopeful Mr Jankovsky.

But for a gloomy Mr Poruba, peering at his wall map, it is obvious that the dreams of a Czech Republic with a modern road infrastructure are vanishing into the hazy distance, thanks to spending constraints both in Prague and in Brussels.

“We are waiting for the next budget and we are hoping for more,” he says.



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## Doing Business in the Czech Republic



Minority report: Robert Chramec is proud of his five-year record as a refuse collector. 'Fifty per cent of my colleagues are Roma,' he says

Kester Eddy

# Discrimination is 'lost opportunity'

## Roma

Governments have increased efforts to tackle the problem but help still only reaches a small proportion. Kester Eddy reports

It may be 5.30 in the morning, but unlike the gaggle of inebriated tourists staggering towards their hotel after a night's revelling, Robert Chramec is bright-eyed as he prepares to start his day near the Andel shopping centre, in central Prague.

A door to a house yard opens, its resident mutters a friendly greeting, and Mr Chramec enters to collect his first wheelie-bin of the shift. Within minutes, the dustcart arrives, the bin is emptied, returned and – with Mr Chramec standing on the rear steps – it roars off to its next port of call.

Mr Chramec, 28 this month, is proud of his five year record as a refuse collector.

"I worked as an apprentice

upholsterer, but couldn't get a permanent contract. This is hard work, but I like it. I finish by noon, and I'm outside all day; nobody's looking over your shoulder, and it's good money," he says.

His employer, AVE, is a practical advocate of equal opportunities – this has been very important for Mr Chramec, one of the Roma minority.

"There's no discrimination at this firm. I'd say 50 per cent of my colleagues are Roma, and they employ Vietnamese and other immigrants. It's a bit of a shock for some of the [Czech] guys when they join," he says. After deductions, Mr Chramec makes about Kč20,000 (\$1,170) month, and although half of this goes on rent, he counts himself fortunate.

Most "Czech" Roma are descendants of families moved from Slovakia into mining and industrial centres by the former communist Czechoslovakia after the second world war.

When the regime collapsed in 1989, they were the first redundancy victims as heavy industry sought to adapt to the free market. In human terms, the costs have been devastating.

According to a World Bank report in 2008, only 27 per cent of working-age Roma in the Czech Republic had regular employment. After repeated attempts failed to secure work, 55 per cent considered themselves outside the labour force altogether.

Deprivation sharply increased ethnic tension between communities, with ethnic Czechs com-

monly perceiving the Roma as "living off social benefits". In a follow-up report last year, the World Bank argued this perception was false, and warned that failure to include Roma in the legitimate workforce – not least by eliminating discriminatory practices in education – is a lost economic opportunity for the entire nation.

The data suffer from the lack of accurate figures on the Roma population, estimated at between 160,000 and 300,000. Nonetheless, in recent years, governments have increased efforts to address the problem, allocating €6.4m (\$9m) from the state budget to Roma support in 2009, a jump of 54 per cent on 2008.

Partly as a result, the Agency for Social Inclusion, a state-funded body, has been able to advise on some 70 pilot projects designed to ease the plight of two dozen of the most deprived parts of the country, so-called "excluded localities" – primarily, though not exclusively, Roma communities.

Martin Simacek, director of the agency, is under no illusions as to the size of the challenge.

"We are dealing with the second generation of unemployed, people in their 20s, who have grown up with parents out of work, so completing any task is a step in improving personal discipline," he says. The agency co-operates with local authorities and NGOs in job creation schemes that range from basic duties such as cleaning the streets and clearing snow to collecting and preparing obsolete IT equipment for recycling – the latter a particularly successful scheme in Bruntal, northern Moravia.

So far, the projects have involved about 8,000 people, only a small proportion of the 90,000 or so population in the 330 "excluded localities".

"We need to motivate local authorities to do more. I'd say only 20 per cent are really keen to do something," says Mr Simacek. Compared with the provinces, life in the capital offers much greater opportunities for those willing or able to take advantage of them – as shown by Mr Chramec.

"Robert is very special, because his parents focused on his education. Still, I'd say that anyone in Prague who really wants to can get a job, though it may be unpleasant work," says Katerina Hulova, director of the Andel branch of People in Need, an NGO helping disadvantaged people from all ethnic backgrounds.

But, she says: "In the north-west, in places such as Cheb, Usti and Decin, and in northern Moravia, it's very difficult to find work, even for the majority Czech population."

## The next challenge is to remain competitive

### Automotive industry

A network of parts suppliers has grown up to service global carmakers, writes Nicholas Watson

It is 20 years since Volkswagen bought a stake in Skoda.

During that time, the Czech carmaker has grown from a builder of low-cost vehicles for the region to one that exports to the huge Bric markets and has begun eating into sales of the parent brands.

Attending the April 15 celebrations at Skoda's headquarters at Mlada Boleslav were Martin Winterkorn, VW chief executive and Vaclav Klaus, the Czech president, who played a part in the original decision to sell Skoda to the German carmaker in 1991.

"It was VW or Renault, and even I, not an expert in cars, was thinking: I buy my cheese in France and my cars in Germany," he told attendees.

At that time, Skoda sold about 187,000 units a year of two models; in 2010, it sold a record 762,600 vehicles spread across

five distinct models, some 10 per cent of VW's total sales for that year.

The experience of Skoda mirrors the car industry as a whole in the Czech Republic. In VW's wake the Toyota-Peugeot-Citroen consortium arrived, followed by Hyundai, which together with local producers such as Tatra and Avia produced 1.078m vehicles in 2010, up 9.4 per cent from 2009 and more than double the figure for a decade ago.

As these global carmakers arrived, so a vibrant network of parts suppliers grew up in the Czech Republic and Slovakia, which had managed to attract PSA Peugeot Citroen and Kia Motors.

The development agency CzechInvest says that more than half the largest global automotive suppliers have operations in the country, which provides carmakers with an almost complete local supply chain and thus, significant cost advantages.

The challenge for the Czech car industry over the next decades is to remain competitive.

IHS Global Insight, the consultancy, expects car production in the country to reach 1.23m by 2015 through the expansion of

existing facilities – at the April 15 event, Skoda also broke ground on an extension to the plant that will double production of its Octavia model.

But there is increasing competition from countries in the region. Daimler chose Hungary for its first Mercedes factory in central Europe and Audi is investing almost €1bn (\$1.4bn) to expand its factory there.

Petra Safkova, manager at PwC, the consultancy, in Prague, says that while there is probably not that much scope to improve the costs of production

'Skoda want to double its sales [to 1.5m units by 2018] but how do you do that without cannibalising your mother brands?'

in the Czech Republic, "suppliers and [original equipment manufacturers] could make their production more efficient by removing bottlenecks and improving the efficiency of the supply chain".

Another challenge, ironically, stems from the car industry's



Quality marquee: Why pay more for a Volkswagen?

Reuters

very success. Skoda cars had fitted neatly into VW's product line, with Audi at the top, followed by VW.

But the quality of Skoda cars surpasses that of Seat, a struggling Spanish division of VW, and is now bumping up against parent brands.

There is anecdotal evidence of European executives rejecting their Audi A6s for the top-of-the-range Skoda Superb that costs about 40 per cent less. Skoda brands, according to a German study, are eating into about €500m of sales a year from the VW and Audi brands.

"Skoda want to double its sales [to 1.5m units by 2018], but how do you do that without cannibalising your mother brands? Frankly, Skoda cars can't get much better before people start asking themselves: 'Why pay more for a Volkswagen?'" says Tim Urquhart, analyst at IHS Automotive.

VW thinks the answer lies in

the huge emerging markets to the east, which could lift the German carmaker above Toyota to become the world's biggest.

Besides the Czech Republic and Slovakia, Skoda makes cars in five other countries: India, China, Russia, Kazakhstan and Ukraine.

It has seen sales grow fastest in Asia. In India, it sold more than 20,000 units last year, up 38 per cent on the year before. But that was dwarfed by China, where sales topped 180,000.

"About one in four Skodas sold last year was in China – that's a remarkable achievement," says Mr Urquhart.

That is all the more remarkable given that Skoda only began producing cars there from mid-2007 at its Shanghai Volkswagen plant – the 500,000th vehicle rolled off the assembly line in May.

"China is the most important growth market for us," says Winfried Vahland, the chairman of Skoda.

## Stick-to-basics policy has paid dividends

### Banking

Conservative approach has benefited both the nation and banks' mainly foreign owners, reports Jan Cienski

Martin Kraus is looking for funds to invest in his company, but he is finding it difficult to persuade banks to lend him the money for equipment to make toys and furniture for kindergartens.

"The reaction of banks in the Czech Republic has been basically the same for me as everywhere else," complains Mr Kraus.

"If you want to start a business, even one that's invented something as great as the light bulb, they won't lend you the money, because your company has no history."

Mr Kraus's troubles are a sign of the caution among many Czech banks, as the sector continues its recovery from the economic crisis.

Nonetheless, business loans did begin to increase from the second half of 2010.

"A new credit cycle is starting," says Petr Knapp, a board member responsible for corporate banking for the Czech bank CSOB, which is owned by Belgium's KBC.

"Credits are rising and will continue to rise, first and foremost with companies."

In the first quarter of this year, CSOB saw its overall loan portfolio rise 2 per cent, although corporate lending fell 1 per cent compared with the same period last year.

Ceska Sportitelna, the country's largest bank and an affiliate of Austria's Erste Bank, reported that retail lending was flat in the first quarter, while corporate lending increased by an annual 1 per cent.

The sluggish growth in demand is a result of the bruising suffered by businesses and consumers in the recession, when the economy contracted by 4.1 per cent in 2009 before returning to 2.3 per cent growth last year.

Businesses implemented restructuring programmes when the downturn hit, and are now able to take advantage of German growth, which is boosting Czech exports, without having to increase investment. Consumers are also warier of debt.

"The behaviour of households has changed significantly because of the crisis, says Pavel Kysilka, chief executive of Ceska Sportitelna. "Before the crisis, we had spending euphoria; people would come and ask for money. Now, they're much more cautious."

While lending may not be growing fast, the sector's indicators are solid; the country has one of the most stable banking systems in Europe.

Even during the crisis, Czech banks saw their operating income increase by more than 30 per cent to Kč59.7bn (\$3.5bn) in 2009. Bank profits fell slightly to Kč55.7bn in 2010, hit in part by rising loss provisions. However, the first quarter of this year saw strong profits, as banks reduced provisions for problem loans.

Non-performing loans are cur-

rently at 6.4 per cent, down slightly from their peak this year.

"We expect to see a significant improvement in NPLs this year," says Mr Kysilka.

The conservatism of Czech banks served them well. They never dabbled in the exotic instruments that brought low US and west European institutions, preferring to remain with the staid business of taking deposits and giving loans.

"Our stick-to-basics approach proved itself during hard times, there is no need to change it," says Mr Knapp.

Czech banks granted very few foreign currency mortgages, unlike banks in Poland and Hungary, where such loans were very popular. These pose balance sheet problems because of the mismatch between short-term deposits in zlotys or forints and long-term loans denominated in euros or Swiss francs.

"The Czech financial sector has no problem with FX exposure," says Vladimir Tomsik, the deputy head of the Czech National Bank.

The central bank's benchmark interest rate – now at 0.75 per cent – has in recent years generally been below the eurozone, meaning that few have wanted to take the risk of borrowing in a foreign currency.

The banking sector is more than 90 per cent foreign owned, and has provided steady profits. The system also looks well insulated against shocks.

In stress tests run by the Czech National Bank, which posit a much deeper recession than the European Central Bank assumes in its tests, the banking system as a whole

'Before the crisis, we had spending euphoria; now, people are much more cautious'

stays stable and maintains an aggregate capital adequacy ratio of more than the regulatory minimum of 8 per cent.

"The Czech financial market is an outlier, because there is a surplus of liquidity," says Mr Tomsik.

The capital adequacy ratio for the banking sector is 15.4 per cent, and the country has one of the highest loan-to-deposit ratios in the EU, currently about 74 per cent.

The long-term outlook is buoyed by the fact that the country is still underbanked compared with western Europe.

Household loans are about 30 per cent of gross domestic product, far below the overall EU level of almost 70 per cent.

In a recent report, Standard & Poor's, the credit rating agency, sees possible pitfalls in sluggish increases in lending as well as a potential rise in the central bank's two-week repo rate – at which it lends to commercial institutions.

The report says: "The biggest challenge for Czech banks is therefore... to expand their revenue base, because there are very few further improvements to be made in their already lean cost base and declining credit costs since 2010."



CSOB's loan portfolio rose 2 per cent in the first quarter

Bloomberg

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## The economy is open but weak institutions are a worry

Continued from Page 1

White & Case, the law firm, found that the Czech Republic had the greatest number of pending arbitration cases in Europe between the government and investors.

However, those problems have not halted a steady stream of new investors. Foreign direct investment rebounded last year to

\$6.7bn from a low of \$2.9bn in 2009.

The main attraction is the close economic links with Germany.

Czech factories have become part of the German supply chain and are taking advantage of Germany's surprisingly strong export-led recovery.

"The Czech Republic is fortunate by virtue of its geography and its tradi-

tional strengths in engineering and a well-educated and motivated workforce," says Jan Fanta, a partner with Ernst & Young, the consultancy, in Prague.

"The country is riding on the coattails of the German recovery, and for as long as that continues, the Czechs are well placed."

The biggest risk to the economy is that the

German economy and that of other leading export destinations run into trouble, because the domestic market has not yet recovered from the crisis, and demand remains sluggish.

On its own merits, the Czech economy is rebounding well.

The banking system is stable and one of the best capitalised in the EU, and

real estate is seeing some signs of recovery.

The biggest question is whether fractious politicians can muster the will to push through reforms that would make the country more business-friendly and fiscally secure.

"The measures we are taking are neither popular nor populist," admits Mr Necas. "We are taking steps that we must take. For this

reason, we don't expect [they] will be joyfully received by the public."

"What we are trying to do is to explain to the public the necessity of these steps and the risks that passivity would bring."

"Without reforms, a scenario similar to states dependent on financial assistance from abroad would await us in the near future."

# Plan to inject excitement into country's image

## Tourism

**Kester Eddy** notes a wealth of cultural heritage but some think Prague needs to be more 'trendy'

**O**n the outskirts of Hnanice, a village in south Moravia, a pair of tourists amble past an abandoned fortified bunker, a military marker of a former age, and a reminder that the Austrian border is a mere five minute's walk to the south.

Such a stroll could not have taken place before 1989, when even Czechoslovak citizens needed papers to live in or enter this designated border zone.

"People were cut off, even from my town, Znojmo [the regional centre, 12km to the north]," says Milos Jirasek, manager of the Penzion Vinohrad, a hostelry in the village.

The barbed-wire frontier has gone and, with Czech membership of the Schengen passport-free travel zone, rambblers and cyclists now roam the tracks where border patrols once prowled.

Although the few thousand visitors to Hnanice each year barely compare to the hordes thronging Prague, they are important to the local economy.

"South Moravia has always been poor, relative to Bohemia.

"This pension and others around rely on cyclists in the summer months. Czechs, Austrians, some from Poland, England and the Netherlands; they all enjoy the unspoilt countryside and local wine," says Mr Jirasek.

For Filip Remenec, head of public relations at the Czech Tourist Authority, tiny villages such as Hnanice and its Cold War relics are part of the mosaic that makes the Czech Republic a leading destination.

"Last year we had 6.4m tourists, who spent almost 4 days on average. That is 5 per cent up on 2009, and compares well with the 4.5m going to Poland," says Mr Remenec.

Tourism is one of the country's post-1989 success stories,



Underappreciated treasures: Telc, where the old town square is formed by lines of renaissance and baroque houses, attracts only 6 per cent of tourists

Dreamstime

with foreign guest nights doubling from 10.3m in 1995 to peak at 20.6m in 2007, although the economic crisis resulted in a sharp downturn of 10 per cent in 2009.

The sector brings in €5.2bn (\$7.4bn) in foreign exchange, accounting for 3 per cent of gross domestic product, and directly employs more than 250,000 people.

Mr Remenec extols the country's attractions: "We have 12 Unesco World Heritage sites, including Prague, the largest urban Unesco site in the world. There are more than 2,000 castles and châteaux, 36 spa resorts and, something rather less known, 85 golf courses.

"It's a lot for such a small country," he adds.

However, notwithstanding the many attractions in the provinces, the tourism map is very Prague-focused – with some 65 per cent of visitors staying only in the capital. The second most popular attractions – the spa centres in west Bohemia – lured just 7.3 per cent.

South Bohemia, which is home to historical treasures such as Telc, where the old town square is formed by lines of beautiful renaissance and baroque houses, attracted 6 per cent of tourists, but just 3.5 per cent of guest nights.

Mr Remenec accepts that more could be done to promote

the regional attractions, but points out that the capital-provinces divide is little different from, say Budapest in Hungary, where the capital has a very strong international brand.

In addition, Prague airport is an important gateway to the country, particularly for long-haul flights, so it makes sense to promote the capital in international marketing campaigns, he argues.

Today, the city has some 32,800 rooms yet despite improving occupancy rates, hoteliers are restless over issues such as the strong local currency and the industry's perceived low priority in government.

Peter Knoll, general manager

of the Kempinski Hybernaska hotel, says: "Tourism does not have its own ministry and is 'lost' bureaucratically. The sector is a huge income earner for the entire country; it should have a more clear voice at a ministerial level."

In addition, the country and capital are fixated on cultural heritage. "Prague is losing ground against 'trendy' destinations, such as London, Barcelona and Berlin, where they manage to combine [a feeling of] modern lifestyle with historical charm. An 'innovation committee' is needed to put Prague back on the map for these 'new age' travellers," Mr Knoll says. Research has shown the coun-

try to have rather too much of a "calm and relaxing" image, Mr Remenec admits, and the new marketing theme will be "magical and surprising" to inject some excitement into the country's image.

The Tourist Authority is unable to help on the latest blow to the sector's hopes for recovery, however, an increase in VAT on accommodation from 10 to 14 per cent from next year, and to 17.5 per cent from 2013.

Mr Knoll comments: "The implication is that any hope of a rise in profits for hotels will be very limited: increased revenues from the improving market are going to be largely eaten up by the government."

'The sector is a huge income earner; it should have a clearer voice at a ministerial level'

## Capitalism has taken root, capital markets not yet

### Stock exchange

The scars from botched state asset privatisation in the early 1990s remain, writes **Jan Cienski**

The economic transformation of the Czech Republic over the past two decades has been an enormous success – but although capitalism has taken root, capital markets have not.

The Vienna Stock Exchange is hoping to change this by investing in its Prague counterpart.

Vienna took a 92 per cent stake in Prague in late 2008, adding to its growing central European empire, which includes majority stakes in bourses in Budapest and Ljubljana, as well as close ties to exchanges in Romania and parts of the former Yugoslavia.

Being under Vienna's wing may give Prague the depth and liquidity to attract both investors and new listings, some of which have been decamping to the fast-growing Warsaw Stock Exchange, which has become a regional leader in IPOs.

Vienna is planning to have all the exchanges in its group use the Deutsche Börse's Xetra trading system by mid-2012, in order to integrate them more closely, as well as promoting cross-membership in the bourses.

"We do not want to weaken our brother and sister exchanges," says Michael Buhl, chief executive of the Wiener Börse, stressing that the idea is to ensure that each of the exchanges in its group continues to function well in its local market.

For the moment, Vienna's investment in Prague is little more than a marketing exercise, says Petr Koblík, the Prague exchange's general director.

"The more visible fruits of this deal are still ahead of us."

The link with Vienna should prove helpful

because on its own, Prague has not had a smooth run.

The exchange began trading in 1993 with only seven shares, but was quickly overwhelmed by the government's controversial voucher privatisation scheme, which was supposed to move state assets into the hands of citizens.

Hundreds of listings clogged the exchange – which at its peak had more than 1,700 companies trading.

Regulation did not manage to keep up with the onslaught, and many of the companies were quickly stripped of their assets by savvy investment funds – burning many ordinary investors in the process.

The exchange tried to take back the initiative in 1997 by withdrawing 1,301 listings from trading, but the damage had been done.

A capital markets culture – in many ways alien to central European traditions

of capitalism, which share many characteristics with the German bank-financed model – did not take root in the Czech Republic.

The Prague bourse now has 27 listings, some of them very thinly traded, a market capitalisation of €57bn (\$81bn) and average monthly turnover of €1.3bn. IPOs are a rarity, with

'If you look at product volume, Warsaw is clearly the financial hub of central Europe'

only two new listings in 2010: Kit Digital, a technology company and Fortuna, a gaming business.

By contrast, in Warsaw, where the market grew more slowly and was much more closely regulated, the idea of raising funds

through the stock exchange is much more popular among local businesses.

Warsaw has also been buttressed by the Polish government's continuing privatisation programme, which has seen billions of zlotys a year in new issues coming on to the bourse.

"Unfortunately, I don't have a government with lots of companies to sell," says a rueful Mr Koblík.

As Warsaw has grown, it has attracted some Czech companies, including CEZ, the utility, and NWR, the coal miner, which are traded both in Prague and Warsaw.

The investment community is also shifting to the Polish capital.

"We have our IT and back office in Prague, but if you look at product volume, Warsaw has clearly become the financial hub of central Europe," says Jan Sykora, one of the owners of Wood & Co, a central European brokerage and investment bank.

Vienna and Prague are trying to win back business.

Prague has an energy trading exchange, which is making inroads across the region, and Mr Koblík is trying to inculcate more of an investor culture.

"There is a huge potential for growth," says Mr Buhl.

There is also some hope that the government's planned pension reforms will include the creation of a privatised pension system, which would take part of workers' mandatory social security taxes.

In Poland such a system helped create a large pool of funds that were, by law restricted from investing much abroad, pumping money into the local capital market instead.

Pension funds that pool voluntary savings already have €8bn in assets and could be another fillip to the bourse if regulations are changed.

Mr Koblík notes that restrictions that force pension funds not to show an annual loss means they avoid equities, and therefore add little to the exchange.



Source of growth: changes to the pension system could ultimately provide a fillip to the bourse

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## Doing Business in the Czech Republic

# 'Germany factor' boosts commercial sector

### Property

Economic recovery across the border is driving demand for warehouse space, says Jan Cienski

Germany's unexpectedly strong economic recovery has been drawing central European neighbours in its wake – sucking in imports from Czech factories.

Now the "German recovery effect" is starting to spill over into the Czech real estate market.

There has been a steady recovery in the industrial and logistics sector, which has seen building occupancy rates rise in 2010 and into this year. They are now more than 90 per cent nationally.

Some regional markets, such as Ostrava and Plzen, have seen vacancy rates halve from more than 20

per cent at the beginning of 2010.

"Germany is driving demand for warehouse space," says Kevin Turpin of Jones Lang LaSalle, the real estate services company.

As Czech businesses see demand grow, they again want to rent warehouses and logistics centres. In the past, most such space was built by large developers on a speculative basis. Now, after the crisis, construction usually only begins once a tenant has been lined up.

German companies have also had a positive impact on the office market.

The IT operations of Deutsche Börse recently leased 7,500 sq m of space in the newly completed Futurama complex in suburban Prague – nearly half the whole project – consolidating offices that had been scattered around the city.

"In the past year, there has been a clear improvement in the commercial

real estate market," says Tomas Veleminsky, the head of Immorent, a subsidiary of Austria's Erste Group and the developer of Futurama.

Construction has begun on the project's second stage, with an additional 16,000 sq m of space.

Relocations such as that of Deutsche Börse are expected to form the bulk of the action in the office market this year.

Several large banks, such as Komerční Banka, a subsidiary of France's Société Générale, are also looking to consolidate their operations in a single modern building.

Mr Veleminsky says: "It's not really comparable to the early 1990s, when companies were looking for headquarters buildings in Prague. Now, it's more a question of expansion and relocation."

Prague, by far the most important real estate market in the country, saw only one office building com-

pleted in the first quarter of this year. In the whole of 2010, only 42,000 sq m of office space was built, a far cry from pre-crisis levels.

That total is expected to more than double to about 95,000 sq m in 2011, according to Jones Lang LaSalle.

Emerging from the cold shower of the crisis, developers are more cautious about projects, and banks

'Banks are a lot stricter than before the crisis but less so than a year ago'

are also demanding much higher levels of pre-leasing before agreeing to finance construction.

Nonetheless, there are signs of life. Prague has seven speculative office projects on the go.

"Banks are a lot stricter than before the crisis, but less so than a year ago," says Mr Veleminsky.

As life returns to the market, foreign investors, particularly large real estate funds from Germany and Austria are beginning to edge back too.

"We see an increase in investor appetite, particularly for offices," says Holger Schmidmayr, a board member with Sparkassen Immobilien, Austria's longest-standing property investment company.

He says that during the crisis those funds restricted their investments to the most liquid core markets. That left an opening for Czech investors, who accounted for about 80 per cent of the €800m (\$1.14bn) of transactions last year.

The most active investor was the Czech CPI Group, which accounted for almost half of the year's transaction volume.

Analysts expect transaction volumes to reach as much as €1bn this year – still far below the €2.7bn seen in 2007, the year before the crisis.

New retail development has been sluggish, particularly in Prague, which over the past two decades has acquired a modern network of shopping centres and "big-box" superstores.

What action there is tends to be concentrated on upgrading or expanding facilities, with some retailers choosing to venture into smaller towns that lack modern malls.

The residential sector is showing the fewest signs of recovery.

Prices have not fallen far, unlike in some other central European markets, but price increases are still some way off, in large part because developers are still sitting on projects finished in 2009 or 2010, where a large percentage of the units remain unsold.

The stagnant market has scared off small-scale foreign investors, who had seen Prague, one of the most beautiful cities in Europe, as a safe one-way bet on



Deutsche Börse has leased half of the Futurama complex

rising real estate prices.

"The foreign speculators are completely gone," says Angus Wade at Jones Lang LaSalle in Prague.

However, Daniel Heler, deputy general manager of Ceska Sportitelna, the country's largest bank and

a unit of Austria's Erste Bank, estimates that mortgage loans will increase by 25-30 per cent this year, partly because of an expected VAT increase next year that is driving buyers to conclude purchases this year.



Steaming ahead: vapour rises from the cooling towers at the Temelin nuclear power plant. In October, a project to build two reactors begins in earnest

Bloomberg

# For nuclear expansion, money is the problem, not public opinion

### Energy

Nicholas Watson on the three bidders to build two reactors. Some believe state guarantees are needed

In October, a huge project to build two nuclear reactors begins in earnest with the publication of the tender parameters.

The importance of this deal for the three bidders – France's Areva, Westinghouse Electric of the US and a Russo-Czech consortium led by Atomstroyexport of Russia – promises to make this a hard-fought battle.

In 2009, the Czech utility CEZ invited applications for the country's biggest ever tender to build two reactors at its Temelin nuclear power plant, with an option for up to three more reactors at sites elsewhere in Europe, in what could amount to an investment of more than €20bn (\$28.6bn).

When it announced the three bidders that had qualified to participate in the tender, a mass lobbying effort began via the press.

Westinghouse, now a unit of Japan's Toshiba, has been par-

ticularly assiduous in its attempts to get out its message.

Hardly a week goes by without Norman Eisen, the US Ambassador to Prague, singing the praises of Westinghouse's bid. Given his close ties to President Barack Obama, it is clear the administration is giving its full backing.

Westinghouse will need all the help it can get. Its bid took a knock in May, when the US Nuclear Regulatory Commission (NRC) raised concerns over the design of its AP1000 reactor and said it wasn't prepared to license it, even though ground has already been broken for one such reactor near Augusta in the US state of Georgia.

Westinghouse hit back by saying the design issues are being "misinterpreted and sensationalised", stressing they are "procedural and are not safety" significant. "We will work co-operatively with the NRC and expect to obtain all necessary approvals as planned this fall," it says.

Safety is the main selling point of Areva's bid, something that has taken on added significance since the events in Japan.

Its EPR reactor includes a host of safety features, though they inevitably make it more costly; in 2009, Abu Dhabi chose a tender from South Korea over Areva's reportedly

50 per cent more expensive one.

Areva has the most apolitical pitch, but is no less keen to win for that. "This is the number one priority project for us," says Thomas Epron, Areva's chief representative in Prague.

The Russians, meanwhile, certainly know how to play the geopolitical game. April saw a gaggle of high-profile politicians and businessmen in Prague to play a charity ice hockey match against their Czech counterparts. They included Alexander

A recent poll found national support of 63 per cent for nuclear power, even after events in Japan

Zhukov, the deputy prime minister and Arkady Dvorkovich, presidential economics adviser.

The Russia-friendly Czech president, Václav Klaus, has already come out in support of the Russo-Czech bid, although the general population and a good section of the political elite regard the country with a degree of suspicion.

To allay concerns, Atomstroyexport says Rosatom, the Russian state atomic energy group, could build a nuclear fuel

production facility on Czech soil "to achieve higher energy independence of the Czech Republic" and has promised to subcontract about 70 per cent of the work building the two reactors to local firms.

Critics point out that Atomstroyexport's Czech partner Skoda JS is part of the nuclear division of another Russian company, OJSC.

None of this will count for much if the tender is cancelled. Industry insiders point to CEZ's agreement with McKinsey & Co to have the consultancy draw up a contingency plan, in case the tender does not succeed, as proof the project is in trouble.

Others say this is normal procedure for such perilously long-term projects as nuclear plants – CEZ aims to pick the winner in 2013 and have the reactors up and running by 2025 at the latest, some 17 years after the project was initiated.

Public opinion is not a worry – a recent Gallup poll found national support for nuclear power at 63 per cent, even after events in Japan. A more likely source of trouble is financing.

The cost of building Europe's first pressurised water reactor in Finland was estimated by Areva at €3bn in 2003, but has since grown to about €6bn amid delays.

Together with the possibility of further safety measures stemming from the EU's reactor stress tests and uncertainties over the price and demand forecasts for electricity, some believe state guarantees will be needed to finance Temelin's expansion.

"Without state guarantees, this project is dead," says Jan Ondrich of Candole Partners, a consultancy, adding there are echoes of the collapse in 2010 of Constellation Energy's plan to build a reactor in the US, after the company could not accept the conditions attached to a \$7.5bn federal loan guarantee.

Alan Svoboda, executive director of sales and trading at CEZ, says the utility is the least indebted of the top-10 utilities in Europe. "Plus, we are undertaking all necessary steps to prepare ourselves for financing the project from the balance sheet of CEZ without exposing the company to the risk of lowering its credit rating."

Richard Miratsky of Moody's, the credit rating agency, notes that, while CEZ's leverage has historically been below the industry average, "it has been increasing quite steeply over the past two years and it's a question how CEZ will manage its leverage in future, given its significant capex investment programme."

# Friends devise set of winning formulas

### Profile

### RSJ Algorithmic Trading

Jan Cienski on the rise of a 'black box' trading company that is the largest presence on the NYSE Liffe

A sign in Karel Janecek's office spelling out the annual turnover of his company, RSJ Algorithmic Trading, has so many zeroes it makes the eyes swim. It reads Kc2,600,000,000, 000,000 (about \$155,000bn).

As trams rattle by outside the open windows of RSJ's offices in the heart of old Prague, Mr Janecek, a 37-year-old maths whizz, explains how he built up one of the world's largest "black box" trading companies, which uses sophisticated mathematical models and high-speed computers for marketmaking and directional trading.

RSJ trades financial derivatives on its own account and is the largest trader, and also a marketmaker, on the NYSE Liffe, the futures exchange owned by NYSE Euronext. It also has a large presence on the CME in Chicago and Deutsche Börse's Eurex unit.

Algorithmic trading is increasingly common in options, futures and foreign exchange markets, although it has come under fire, particularly in equities, with some blaming it for exacerbating the May 2010 "flash crash" in the US, when the Dow Jones plunged more than 1,000 points in 20 minutes before rebounding.

But Mr Janecek maintains that, in the futures market at least, algorithmic traders such as RSJ provide liquidity and stability.

He owns 42 per cent of RSJ (the rest is held by 10 friends), and is cagey about revealing profits. Marketmakers make a living from the tiny spread between bid and offer prices. Their turnover is so high because of the enormous number of trades they can put out from their "black box".

Controversies about global markets were the furthest thing from Mr Janecek's mind when he started his company in the early 1990s in Plzen, a city more famous for its lager beer than its financial acumen. He dabbled in stocks on the nascent Prague Stock

Exchange, which was then flooded with issues after the voucher privatisation that attempted to transfer

shares of state companies to private hands.

Initially, he used his own money only, then acquired a few clients, but was doing little more than \$500 a month of business. In 2000, he shifted out of stocks into fixed income trading on the Liffe.

Within two years, as he gained clients, the cost of trading plunged and he saw the possibility of refining the business.

"I realised we could use mathematics to trade as marketmakers," he says. With friends, he came up with a series of formulas. The early strategy was fairly clunky, with traders manually placing limit orders, but by 2003, RSJ was using automated marketmaking.

Algorithmic trading has since become increasingly complex, raising barriers to entry for anyone hoping to follow in RSJ's footsteps. "Today, it would be impossible to do what we did when we started. We would have been crushed."

To start with, RSJ used servers in the Czech Republic, but latency – system delay – of 60 milliseconds to London and 200 milliseconds between Prague and Chicago placed the firm at a big disadvantage. It now has servers at the exchanges where it does business.

RSJ has also continually tweaked its models. Five people sit in front of enormous screens in the room next to Mr Janecek, monitoring trading flow and gathering data to fine-tune the algorithms.

The need to stay on top of the models became apparent in 2007, when markets were shaken by the first stirrings of the global economic crisis.

RSJ suffered a loss for 2007, but the new mathematical model created that year proved sturdy, surviving the chaos spawned by the collapse of Lehman Brothers in 2008.

"We are pretty robust now and could survive any crisis," Mr Janecek says confidently. RSJ has become so large that there is little scope to grow in the markets where it currently does the bulk of its business.

Local exchanges such as those in Prague and Warsaw are too small, illiquid and opaque to be of much interest. The next target is Asia, although issues of liquidity and exchange fees are slowing plans to begin trading there.

There are also thoughts on moving into algorithmic share trading, although the market is much more complex than for derivatives because several venues trade the same stock.

Having made his fortune on open and transparent markets, Mr Janecek is now trying to inculcate the same values in his home country, spending increasing amounts of time on his foundation, the Anti-corruption Endowment, which is trying to battle the growing plague of corruption.

"I am making use of the fact that RSJ does business abroad and is regulated abroad. I can laugh at them, but they can do nothing to me," he says.

"The problem here is how government officials abuse their power."

www.ft.com/tradingroom

Karel Janecek: 'We are robust and could survive any crisis'

