Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 4, Issue 2

02.02.2007

ECFIN COUNTRY FOCUS

Highlights in this issue:

- **Foreign enterprises have outperformed domestic counterparts**
- **Foreign investment has raised overall productivity and competitiveness**
- **Domestic firms have been crowded out in certain sectors.**

Foreign direct investment in the Czech Republic: a challenge for domestic firms

*By Neil Kay**

Summary

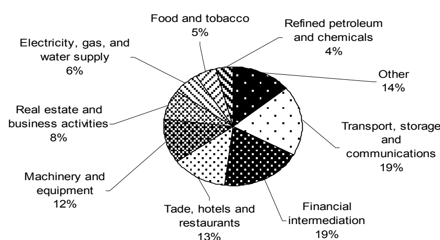
The Czech Republic has been one of the primary recipients of foreign direct investment (FDI) among central and eastern European countries. Soon after transition, it attracted the attention of foreign investors based on sound economic fundamentals and the opportunities offered by early privatisations. Substantial foreign investment over a fifteen-year period has profoundly affected the structure and performance of the economy. This Country Focus looks at the way in which foreign investment has influenced productivity and market dynamics, including intra- and inter-industry spillovers, and the expansion of the economy as a whole.

Development of foreign investment

Following the velvet revolution in 1989, the first democratic elections led to a comprehensive privatisation programme, one of the earliest in the region. In contrast to neighbouring countries, the Czech Republic focused privatisation on domestic ownership, granting no fiscal advantages to foreign investors. These large domestic privatisations and the consequent upsurge in small Czech enterprises helped economic growth up to 1996, aided by cost advantages in export markets and a substantial devaluation of the Czech koruna. However, easy credit from a mainly state-owned banking sector combined with a lack of modernisation led to the existence of a large number of weak enterprises, and in 1996, the Czech economy headed into recession with rising wage costs, escalating inflation and a burgeoning current account deficit.

The Czech Republic has been one of the primary recipients of foreign investment in eastern Europe

Graph 1: Distribution of FDI stock in the Czech Republic 1993-2002



Source: Czech National Bank 2004

Learning the lessons from earlier privatisations and in need of foreign capital, the government introduced an incentive scheme in 1998 for foreign investors. FDI

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inflows increased substantially, reaching more than three times the average level in the RAMS (recently acceded Member States) by 1999 including an influx of greenfield FDI. EU countries, principally Germany, currently account for over 80% of inward investment.

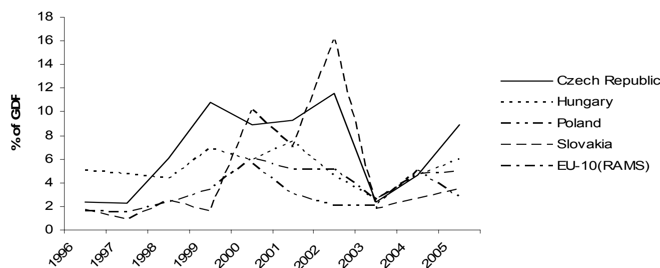
FDI inflows increased markedly during the period 1998 to 2002 due to the privatisation of large banks and utilties.FDI inflows dipped in 2003 due to the disruption caused by severe flooding in 2002, since when they have recovered rapidly toward previous levels.As to the sectoral breakdown, in broad terms the focus of foreign investment has gradually shifted from manufacturing and trade industries, as shown in Graph 1, to the finance industry and, more recently, to high-tech industries and the service sector (UNCTAD, 2006).

Underlying factors and influences of FDI

A number of factors underpin the substantial FDI flows to the Czech Republic. The country enjoys a central location between more developed western European economies and developing eastern European neighbours. It also emerged from transition with a strong industrial base and a highly skilled and relatively cheap labour force, as well as a high quality of infrastructure that has continued to be developed. These factors were complemented by government incentives introduced in 1998 and 1999 providing subsidies to greenfield and brownfield investments, initially in manufacturing and further extended to all sectors. The combination of incentives and opportunities from large privatisations pushed FDI to record levels in 1999-2002 (Graph 2). Macroeconomic stability has also been an essential factor (Kral, 2004, Brada et al., 2004), underlined by the fourfold increase in FDI from 1997-1999 as the Czech economy pulled out of recession. Finally, the prospect of and lead-up to EU accession provided a further stimulus and assurance to foreign investors. [

Sound economic fundamentals and government incentives have encouraged an influx of FDI

Graph 2: Comparative FDI inflows 1996–2005



Source: Commission services

Foreign investment affects an economy in many ways and the Czech Republic provides an excellent test-bed given its relative seclusion prior to transition. In addition, enterprises in the Czech Republic have conformed to international accountancy standards since 1992 (Evenett and Voicu, 2001), improving the availability and reliability of data.

The following three sections examine how foreign investment has influenced the performance of the Czech economy. The first section looks at the performance of enterprises receiving foreign investment; the second at the effect those enterprises have had on domestic firms, in particular, on productivity and market dynamics, and the third at the overall impact of foreign investment on the economy as a whole.

While being beyond the scope of this Country Focus, FDI can also have significant socio-economic consequences: for instance, wage disparities can develop between foreign and domestic employers (Skuratowicz, 2005), regional disparities can be accentuated by the localisation of FDI which may also bring government-assisted infrastructure development, and social costs can be incurred from the displacement of domestic firms under pressure from foreign competitors.

Performance of foreign enterprises

In comparative terms, foreign firms appear to have been considerably more profitable than domestic Czech firms. This has been the consistent conclusion of

empirical studies focusing on enterprise performance. For example, total factor productivity has been found to increase more in firms with foreign investment, and more still in firms with foreign ownership over the period 1994-1998 (Djankov and Hoekman, 2000). The same study also found increases in productivity, investment and market share of target firms following foreign acquisition.

Foreign enterprises have outperformed their domestic counterparts

The significance of foreign ownership was underlined in a further study (Hanousek et al., 2004) analysing the performance of medium and large firms from the early privatisation programme (1991-1995). Private ownership was only correlated with better economic performance if owners were foreign. It appeared that foreign firms had engaged in strategic restructuring, increasing turnover and profits, while domestic owners had reduced sales and labour costs. Interestingly, the same study found that Czech enterprises which remained in state hands on the whole performed better than privatised domestic enterprises, suggesting that the state had induced some profit-oriented restructuring.

The productivity gap between foreign and domestic enterprises was also emphasised by a firm-level study looking at FDI effects across central and eastern Europe (Torlak, 2004), although they were less pronounced in the Czech Republic than in Poland, Romania, Bulgaria and Hungary, perhaps due to the higher productivity of domestic firms prior to receiving foreign investment. In addition to profitability and productivity, the size of foreign enterprises was also found to be larger than domestic enterprises in several aspects (Evenett and Voicu, 2001) by another empirical study focusing on the years leading up to recession (1994-1998).

All studies have indicated that enterprises receiving foreign investment, or under foreign ownership, outperformed their domestic counterparts. However, it is likely that the superior performance was not only due to the contribution of foreign capital and influence, but also partly leveraged existing potential, as outside investment would most likely have been attracted to enterprises already displaying reasonable performance.

Spillover effects on domestic firms

Most of the economic literature emphasises the positive spillover effects of FDI, namely advances in productivity, technical expertise and business competence through the transfer of these elements from foreign to domestic enterprises and through the labour force as a whole, augmenting the human capital base. However, the introduction of large-scale outside investment is thought to also raise the bar to market participation and thus crowd out domestic investment.

There is mixed evidence of positive spillovers on domestic firms

Empirical evidence from the Czech Republic points to a mixed experience for domestic firms. On the one hand, a number of studies have suggested that the introduction of large-scale foreign investment led to negative effects and partial crowding out of domestic firms. For example, based on firm-level data from the period 1994-1998, an industry-wide inverse relationship was detected between the extent of foreign investment and the turnover of domestic firms (Djankov and Hoekman, 2000). This finding was similar to that of a study focusing on regional effects (1993-1998) which indicated that the productivity of domestic firms had declined in proportion to the level of foreign investment (Torlak, 2004) in a given industry. A cross-industry study using data from a similar period (1994-1998) found no positive effects on domestic firm performance (Evenett and Voicu, 2001) and this conclusion was consonant with the findings of a case-study analysis of the Czech Republic as well as several other central and eastern European countries (Biegelbauer et al., 2001).

FDI stock has been shifting towards higher-value sectors

However, these negative or neutral findings stand in contrast to those of other studies that have detected positive effects. For instance, the introduction of foreign investment was found to have a positive effect on the entry rates of domestic firms at intra- and inter-industry level (Ayyagari and Kosova, 2006), across all industries, during the period 1994-2000. The positive effects were perceived to be stronger through forward linkages between foreign suppliers and downstream domestic firms, greater in services than in manufacturing, and wider-ranging in more competitive industries. (However, the same study also found an inverse relationship between foreign presence and domestic firm size, suggesting a degree of crowding out.)

Positive effects were also indicated by a study focusing on the liberalisation of the services sector (Arnold et al., 2006) in the post-recession period, 1998-2003, suggesting that the sector had a positive impact on the performance of downstream manufacturing industries which relied on services inputs. When several aspects of liberalisation were considered, including the presence of foreign providers, degree of privatisation and level of competition, it appeared the level of foreign entry was mostly likely to have been the key factor through which services liberalisation contributed to an improvement in downstream manufacturing sectors.

In summary, no clear picture emerges of the effect of large-scale foreign investment on industry dynamics. Rather, the empirical studies tend to highlight the complex nature of industry restructuring during a phase of rapid expansion and transformation in which there was an overall rise in productivity and performance levels which undoubtedly posed a challenge to domestic enterprises.

The banking sector has been rapidly transformed

The extent of the challenge has perhaps been most apparent in the transformation of the Czech banking sector. Following transition, a single national bank was converted into four state-owned entities at the same time as new banks began to enter the market, many of which were Czech-owned. In the background, a state-owned vehicle, Konsolidačni banka, was also created to take over a legacy of bad loans inherited by the new state-owned entities and provide stability to the sector as a whole. While the number of new banks rose steeply, many new entrants, in particular those under Czech ownership, faced competitive pressures due to undercapitalisation. Problems in the sector deepened with the economic recession, invoking further state intervention and heralding a comprehensive programme of privatisation, in 1998, in which large government stakes started to be sold to foreign banks. The influence of foreign banks has continued to increase and currently accounts for over ninety per cent of banking assets. In parallel, profitability has risen consistently in the sector since 1998 (Barta and Singer 2005).

Overall impact and future of FDI

Productivity in the Czech economy as a whole has risen in tandem with FDI inflows. In this respect, the low productivity growth prior to 1997, in which the Czech Republic lagged behind both Hungary and Poland, can be associated with a relative lack of foreign investment. This helped foster a soft business environment dominated by newly 'privatised' domestic firms with considerable labour cost advantages, as well as a favourable export environment, in which there was little pressure to modernise. The sluggish growth in labour productivity ran parallel to equally weak growth in TFP pre-1997, which was significantly below average for the RAMS and made a negative contribution to overall growth (Graph 3).

Productivity has climbed with foreign investment

Graph 3: Real GDP growth and its components

Source: Commission services

FDI inflows started to surge from 1999, following a government stabilisation package and fiscal incentives offered to foreign investors, accompanied by rising productivity levels and the start of a period in which TFP has made a positive contribution to growth – although, despite the record levels of foreign investment, the contribution of TFP to growth from 2001-2005 was only equal to the RAMS average, indicating that the conversion of investment into productivity may not have been optimal.

The strong and consistent growth of the Czech economy post-recession, in conjunction with the success of foreign enterprises, strongly endorses the benefits of

FDI. In particular, the rise in productivity levels underlines the importance of FDI in the catching-up process of transition economies (European Commission, 2006[b]). The Czech Republic has so far displayed marked success in competing for foreign investment as a result of fundamental economic factors and the incentives provided by the government. Accession to the European Union has given a further boost to the level and diversification of FDI stocks in the Czech Republic, as it has in other RAMS (European Commission, 2006[a]), by giving unrestricted access to the EU market where the large majority of inward FDI originates. Furthermore, foreign investment has been relatively stable, with around fifty per cent of profits, representing nearly a third of FDI inflows, being reinvested. However, competition for FDI is likely to intensify in future within central Europe, where FDI flows to Romania and Bulgaria have started to rise (EBRD Transition Report, 2006), as well as globally, particularly in manufacturing and other labour-intensive industries. The positive impact of FDI on the Czech economy as a whole may also have been felt through other channels than economic spillovers as outside investment tends to exert broader pressure on the business, legal, institutional, and political environment which, although less tangible, can have a profound and reciprocal effect on an economy.

The FDI market is increasingly competitive

While the Czech Republic has continued to attract strong FDI inflows and somewhat consolidated its position as a preferred location for the automobile industry, there remain challenges for the future. The comparative advantage afforded by cheaper labour costs will be gradually reduced with rising wage levels. Moreover, the FDI flows generated from privatisations are coming to an end. Therefore in order to continue to attract foreign investment it will be essential to attract FDI in higher value-added industries involving advanced technology and research. This would imply increased spending on education and R&D spending from public finances as well as further incentives for the private sector to contribute to the stock of human capital to attract foreign investment to these sectors. In addition, competition for foreign investment will continue to focus on macroeconomic stability as well as external competitiveness, which remains particularly important in the case of the Czech Republic owing to the large degree of export-oriented FDI (Kral, 2004).

Conclusion

The Czech Republic has been one of the primary recipients of FDI among central and eastern European countries as a result of sound economic fundamentals and the actions of government to attract foreign investment. The evidence from empirical studies, focusing mainly on the period prior to the millennium, indicates the superior performance of foreign competitors over domestic enterprises. This is to be expected given that Czech firms emerged from a planned economy to face competition from enterprises with higher levels of technology, capital investment, and established business models. The performance gap appears to have been smaller in the Czech Republic than in its other central and eastern European neighbours, perhaps due to the comparatively advanced state of development of the Czech economy, while the transformation of the banking sector clearly demonstrates the significant challenges faced by domestic enterprises.

The evidence of spillover effects appears mixed with no consistent picture emerging from empirical research. This may in part be due to data limitations. Nevertheless, the impact on the overall performance of the Czech economy has been undoubtedly positive with respect to productivity and growth. In particular, the consistent rise in productivity in parallel with substantial FDI flows underlines the importance of FDI in the catching-up process in promoting greater efficiency and industry restructuring. Continued strong FDI flows are therefore not only beneficial but most likely essential in the medium term to sustain the record growth rates of recent years.

The future outlook suggests no immediate risks to the currently high levels of foreign investment, although countries like the Czech Republic will come under increasing pressure from eastern European neighbours as well as global competitors in labour-intensive industries. It will therefore be essential both to attract foreign investment in higher value-added industries associated with the knowledge-based economy and to foster greater domestic investment in order to balance some of the volatility risk in an increasingly competitive environment. Such future high levels of foreign investment will be underpinned a range of factors highlighted in the Commission's assessment of the 2006 Czech national reform programme including macroeconomic stability and continued investment in the human capital base.

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