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MARKET CONDITIONS REPORT 2005 A REAL ESTATE PERSPECTIVE Czech Republic

Prepared by

Erik Webb Dempsey, B.S., MBA

Partner

Property In Prague

Zahrebska 25, 120 00 Praha 2

Czech Republic

Tel: +420-603 820 119

email: erik@propertyinprague.com

web: www.propertyinprague.com

October 2005

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Czech Economics

Inflation

Prices are falling particularly in areas where there is strong competition or where the koruna's exchange rate has a stronger effect. The strengthening koruna is making imports of consumer goods, food, electronic goods and fuels cheaper. Consumer demand in the economy is not increasing the pressure on inflation, either.

In the first few months of this year, inflation will be kept down primarily by an unwinding of the effect of last year's tax changes and by a slowdown in food prices, due among other things to last year's good harvest.

According to the analysts, inflation was to pick up in the second half of this year, mainly because of administrative measures (excise duty on tobacco, **a rise in regulated rents**). However, annual consumer price inflation should remain well below 3%. Oil prices and **a potential higher increase in rents pose risks**.

Overall on the three-year horizon, the consensus of inflation prediction remains broadly stable, fluctuating just below 3.0%. The average estimate was February 2005 is 2.7%. Year-on-year Czech inflation accelerated to 2.2% in September 2005 from 1.7% in August.. The growth was mainly due to an increase in prices of motor fuels by 21.6%, the fastest year-on-year growth in the last five years, according to the Czech Statistical Office.

As of September 2005, month-on-month, consumer prices actually dropped 0.3%. The month-on-month drop in consumer prices was influenced mainly by a decrease in prices of recreation and culture, where prices of foreign holidays fell by 22.7% and domestic holidays by 5.8%.

Prices in the category of food and non-alcoholic beverages kept on decreasing for the third month, although the drop gradually diminished 0.2% in September. In particular, prices of fresh vegetables were lower by 6.2% and potatoes by 3.8%. On the other hand, prices of tropical fruit rose by 9.0% and prices of eggs were up 6.7%.

A higher year-on-year inflation had been expected. In the rest of the year, we expect inflation to continue to accelerate, to over 2.5% at end-year. Inflationary growth is also due to a lower base for comparison from a year ago when prices dropped 0.8%. Some economists even predicted a higher figure. With slower-than- predicted inflation, expectations of an early interest-rate hike by the Czech National Bank will most probably cool down now.

As the new 2005 school year started, prices of education went up by 3.4% of which, for instance, fees for foreign language teaching were higher by 4.9%, fees in after-school care centres by 13.9%, in kindergartens by 4.4%, at private primary schools by 3.1%, and tuition fees at private secondary schools rose by 2.2%. Prices in canteens at schools and at kindergartens also went up. Prices of accommodation services at boarding schools and universities rose markedly (by 54.7%).

In terms of year-on-year comparison, prices of food and soft drinks fell: flour by 19.1%, eggs by 7.1%, potatoes by 7.8%, sugar by 14.2% and pork by 4.8%.

Higher than in September 2004 were especially prices of fresh vegetables (+12.0%), beef (+3.6%) and cheese (+4.1%).

The inflation rate, an increase in the average consumer price index for last 12 months related to the average CPI for the preceding 12 months, stood at 2.0% in September 2005, 0.1 percentage points down from August.

According to preliminary data of Eurostat, the year-on-year increase in the average harmonized index of consumer prices (HICP) in the EU25 was +2.2% in August 2005.

Prices grew most in Latvia (+6.3%) and the least in Sweden and Finland (+1.0%).

Energy Prices

Electricity prices are expected to grow by up to 30% in the Czech Republic. Dominant Czech power producer CEZ says electricity prices will grow in the Czech Republic, and in four years power will be 20 to 30% dearer. Prices will increase for both businesses and households.

In June 2005, CEZ announced that it is the first energy utility in Europe to have sold power for more than EUR 40 per MWh on the German market. The average wholesale price for this year amounted to EUR 34/MWh in Germany. CEZ says this serves as proof that prices will also go up in the Czech Republic, as developments in the Czech market are similar to those in foreign ones. Last year CEZ produced 61 TWh of power, or almost three-quarters of the country's output. About a third was sold abroad.

Compared with other countries in the region, the Czech Republic has the lowest wholesale prices of electricity, according to CEZ data. In Slovakia, prices are 10% higher, in Poland 15%, in Germany and Austria 18%, and in Hungary 22%.

GDP

The recent concerns of some analysts about lower economic output last year were thrown out after the release of the foreign trade figures for November and December 2004. This leads us to conclude an opposite reality... an increase in expected growth.

The Czech economy in 2005 has clearly profited from past foreign direct investment and accession to the EU as well. Net exports remain one of the most significant motors of economic growth this year. The economies have also benefited from the effect of the launch of car production at TPCA Kolín (about 50km from Prague). Investment growth should remain relatively buoyant, despite an expected slowdown. **This year's faster real wage growth (~6%) and continuing rise in household indebtedness are leading to a recovery in consumer demand.** Czech GDP growth is estimated at around 4.4% this year, and the estimate for 2006 is even higher at 4.4%. Despite the higher growth potential of the Czech economy, structural problems on the labour market (i.e. high social taxes, restricted labour mobility due to regulated rents, etc.) continue to put the brakes on high growth.

Looking forward to 2006, the government expects the economy to grow by 4.4% in 2006, the main driving force being domestic demand pulled by household consumption, the high rate of investment, positive foreign trade results and the planned reduction of the tax burden. Some even see 4.4% as too pessimistic. The Czech Prime Minister recently boasted that the Czech economy could reach a stable growth of almost 8% after 2007 and catch up with the EU average by 2013. Indeed, the Czech economy should reach 74.3% of the EU average wealth next year. To catch up with the EU average by 2013, the Czech Republic would need an average annual

growth of 7.8%. Public finance deficits will have to be under control to secure faster growth. In 2008, they have to reach less than 3% of the GDP for the country to adopt the euro at the end of the decade, though this is looking more and more plausible (See “Budget Deficit” below).

The external environment actually remains the greatest risk for economic growth. Negative contributors to the economic growth will be the high prices of oil and non-oil commodities and very low economic growth in countries that are the Czech Republic’s main export markets.

Interest Rates

The reduction in interest rates to 2.25% at the CNB’s monetary meeting in January 2005 took the market completely by surprise. The CNB’s justification for this step included:

- the revision of the GDP time series for 2003 and the resultant downward revision of the assumptions regarding the future growth of the domestic economy,
- the restrictive effect of fiscal policy in 2004,
- the stronger exchange rate
- the worsening outlook for economic growth in the euro area,

There were further reduction in interest rates in February and March, owing to the evolution of the exchange rate of the koruna and the prevailing downside risks of the inflation forecast. As of September 2005, the CNB, as expected, left interest rates unchanged, with the main repo rate sitting at 1.75%, the second lowest level in the EU after Sweden. At this level the Czech economy does not need another rate cut and for the future it is necessary to think about whether the repo rate of 1.75% will not become a threat to the Czech economy. Of eight analysts polled by CTK in early October 2005, only one believed rates will go up this year. The others expected a gradual growth from the middle of next year.

In spite of these predictions, on 27-October, 2005 the Czech National bank (CNB) recapitulated saying it now expects higher inflation and moved to raise interest rates by 25 basis points. The benchmark two-week repo rate now stands at 2.0%, level with the euro zone.

However, the Central Bank’s Govenner, Zdenek Tuma, said he still saw the Czech economy as low-inflationary and could not see any inflationary pressures, a view we share; a view more or less shared by Czech Finance Minister Bohuslav Sobotka who noted the change was “premature”. Still, a change in the forecast led the CNB to raise interest rates by a quarter point Thursday, 27-October. Comments from the CNB confirmed that the central bank would not rush into further rate increases unless inflation diverges from the new forecast in the months to come. Another increase by a quarter point could take place in January 2006.

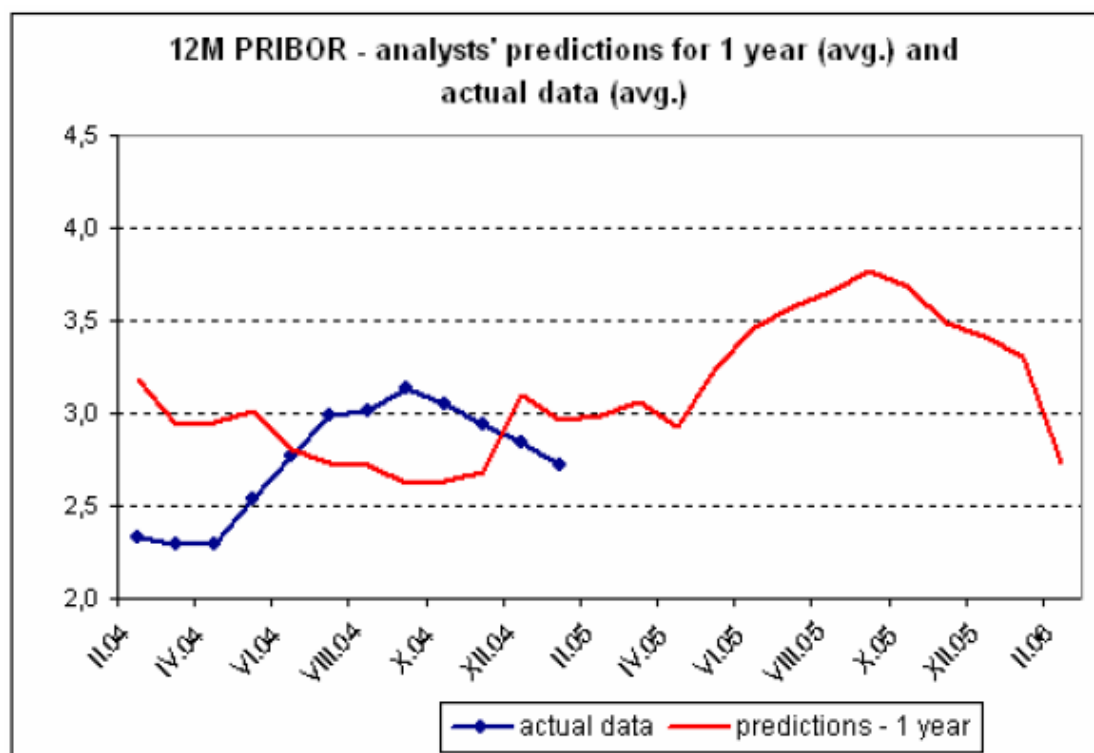
The inflation and GDP growth forecasts are now predicting inflation at 3.0-4.4% in a year. In the previous forecast from July, the CNB predicted inflation at 2.1-3.5% and that Czech GDP should grow by 4.6-5.1% this year. On the other hand, the CNB revised its GDP growth forecast for 2006 slightly down to 3.2-4.7% from a previous 3.3-5.1%. At end of March 2007, Czech inflation should reach 2.3-3.7%.

We believe the inflation forecast was set quite high. The core inflationary pressure comes from energy prices and other external factors. The absence of demand-pull inflationary pressures creates only a minimum space for high energy prices to affect other consumer prices. We note the decision on interest rates was affected particularly by the inclusion of high energy prices and changes to regulated prices, that is, their influence on inflationary expectations. Not that such a scenario of spiralling consumer prices would be inconceivable, but we expect inflation to peak in the first half of 2006 and to decline slightly after that. Most analysts thought central bankers would leave rates unchanged, and some have now agreed the rate increase was premature.

The current situation was similar to 2004, when the CNB raised rates in fear of the secondary impact of EU accession and a growth in taxes. The secondary impact never came, however.

Many believe the persisting strong exchange rate of the koruna has been the primary reason for rate cuts. However, the koruna has traditionally responded to rate reductions with only a temporary slight weakening and appreciation again in the days that followed. As a reaction towards the latest increase, we may expect higher interest rates to boost the Czech crown, which in itself will be another important factor acting as a brake on inflation in the Czech economy.

The CNB will have to monitor the level of interest rates in the Euro zone. Experience from past years indicates that if interest rates get significantly above the European Central Bank (ECB) level, the crown can start firming notably. The solution for the CNB will should be to keep rates at the current level as long as it is sustainable.



Source: CNB, February 2005

Bank Mortgage Rates after interest-rate hike

Some banks have started to raise prices of mortgage loans, the reason being the interest-rate hike of a quarter point by the Czech National Bank (CNB) taking affect 1-November, 2005. It appears the banks are seizing the opportunity to claw back some of their historically low rate offerings as Interest rates on the most popular mortgage loans are growing even more than the CNB rates increased.

HVB Bank, Raiffeisenbank and Zivnostenska banka each raised interest on their mortgages within a day or two following the rate hike. Other banks are considering rate hikes as well, among them for instance CSOB, Ceska sporitelna and Hypotecni banka, are likely to raise interest rates by the end of November 2005.

So far, HVB Bank raised interest rates by roughly 0.3 percent and the actual rate on twenty-year mortgage loan fixed for five years is now 4.3 percent. Zivnostenska banka raised rates fixed for five years by 0.15 percent to 3.9 percent and Raiffeisenbank by nearly 0.4 percent to 4.22 percent.

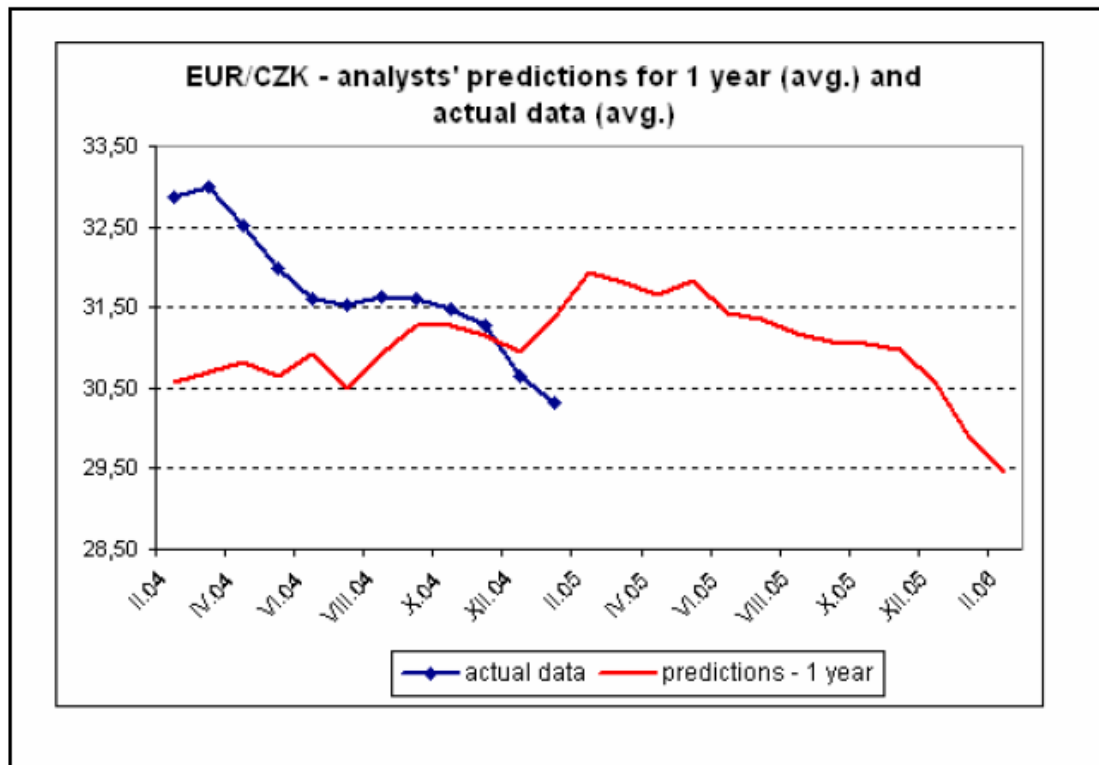
The CZK Exchange Rate

The koruna has in recent days of February 2005 gone below 30.00 CZK/EUR. Some of the analysts expect the domestic currency to appreciate even further, justifying their expectations by the planned privatisations of state property this year, rising export activity by domestic corporations and the positive sentiment regarding the Central European region on the financial markets. Roughly a similar number of naysayers, however, point towards a stagnation or correction of the exchange rate.

According to their comments, a greater weakening is likely in connection with the repatriation of earnings of foreign-owned corporations in the spring and summer months of 2005.

As for the long-term outlook, most analysts incline towards the scenario of further gradual appreciation of the koruna. The average estimate for the one-year horizon is 29.46 CZK/EUR with individual forecasts ranging from 28.50 CZK/EUR to 30.30 CZK/EUR.

The expected long-term appreciation of the koruna is based on faster productivity growth and catch-up with the euro area economic level. The koruna should also be supported by positive trends in the balance of payments. A declining current account deficit – thanks to the favourable evolution of the trade balance – should be accompanied by a growing financial account surplus, as EU membership and the lower risk premium will stimulate portfolio investment. In addition, significant privatisation revenues are expected (Český Telecom, Unipetrol, Vítkovice).



Source: CNB, February 2005

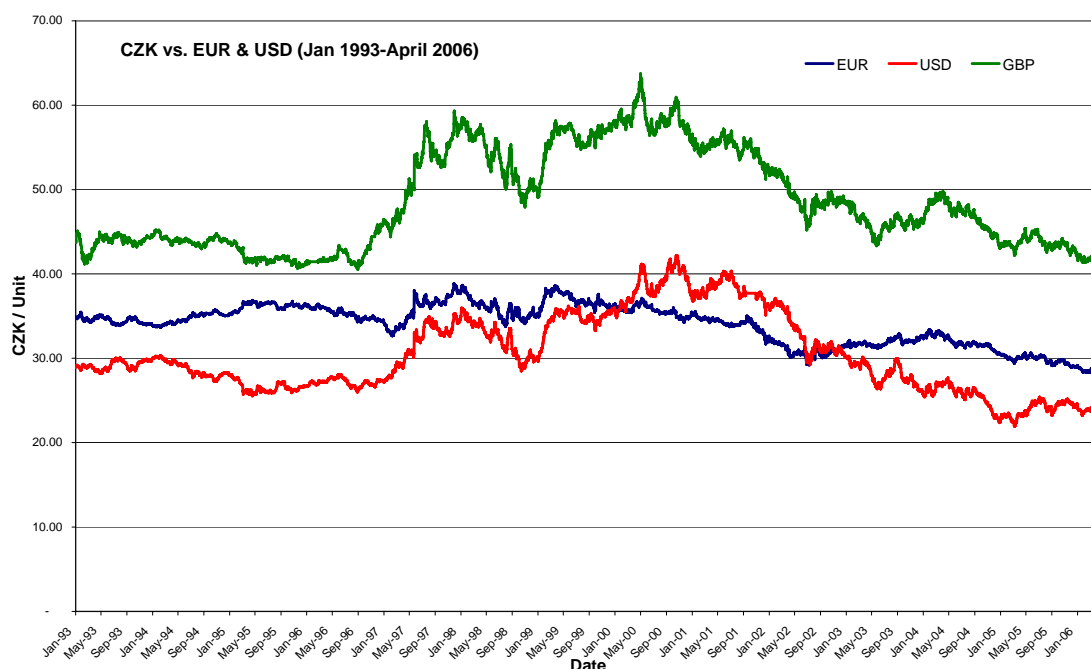
Currency Risk

Because investors from abroad are sourcing their funds denominated in Euros (EUR), GBP, USD, etc., but investing into Czech Koruna [Crown] (CZK) assets there exists a substantial risk in that devaluation of the CZK vs. the foreign currency can wipe out the real profits and gains of the investment. Technically this risk exists, but we strongly take the point of view that there is a higher likelihood of the CZK appreciating over the EUR and GBP in particular than depreciating. There is sound reasoning for this.

Development of the CZK/EUR exchange rate can be described as an exceptional one. Unlike a majority of the regional currencies, it can be characterised by an exceptional nominal stability, meaning a significant real appreciation in the conditions of higher-than-European inflation. While in the beginning of the transformation the exchange rate oscillated on the level of CZK/ECU 33 - 34, this level was maintained also in the next years of the decade with certain signs of depreciation in 1997 - 1999 and dramatic signs of exchange rate appreciation in the last five years. During 2001, especially at the end of the year, the CZK/EUR exchange rate visibly strengthened. While in 2000 the average exchange rate was CZK/EUR 35.61, in 2001 it amounted only to CZK/EUR 34.08. In July of 2002 the CZK/EUR rate touched as high as 29.12. As of 1-September 2003 the CZK/EUR Rate was approximately 32.5 after touching highs in the previous months of May and June 2003 largely on fears of inflationary effects forecasted for EU entry. These fears proved unfounded, and as of 1-October 2005 the rate is back to 29.67 CZK/EUR.

The real estate market in Prague has historically pegged its rental prices to the Deutsche Mark (DEM)/Euro. In recent times the CZK has outperformed the EUR and the market has begun to price in CZK as many long term contracts began to lose money due to the appreciating Czech Currency. It would be expected that the market

would move back to the EUR in the event the CZK began to slide, thus providing a natural hedge. This theory is highly open to debate.



* Note: The DEM exchange rates were normalized to the EUR for this graph by multiplying the DEM/CZK exchange rates prior to 1-January 2000 by 1.95583 (the official multiplier for converting the DEM to EUR).

CZK vs. EUR, USD & GBP

Year	Average			MINimum Value			MAXimum Value			Volatility (StDev)		
	EUR	USD	GBP	EUR	USD	GBP	EUR	USD	GBP	EUR	USD	GBP
1993	34.50	29.16	43.78	33.86	28.22	41.17	35.47	30.09	45.09	0.37	0.49	0.88
1994	34.69	28.82	44.04	33.67	27.23	42.97	35.73	30.33	45.22	0.60	0.90	0.46
1995	36.20	26.54	41.87	35.18	25.52	40.65	36.87	28.06	43.93	0.40	0.60	0.79
1996	35.29	27.14	42.37	34.29	25.98	40.53	36.42	28.09	46.17	0.61	0.43	1.34
1997	35.80	31.75	51.95	32.65	27.14	44.38	38.85	35.29	59.31	1.68	2.41	4.11
1998	35.86	32.28	53.49	33.75	28.49	47.92	38.66	35.96	58.55	1.12	1.99	2.96
1999	36.90	34.63	56.01	34.88	29.63	49.07	38.59	36.19	58.18	0.83	1.37	1.88
2000	35.65	38.64	58.51	34.23	34.79	55.63	37.11	42.20	63.74	0.59	1.81	1.48
2001	34.15	38.12	54.92	31.68	35.11	51.21	35.57	40.34	57.19	0.72	1.04	1.10
2002	30.91	32.81	49.20	29.19	29.23	45.21	32.65	37.12	52.62	0.68	2.31	1.70
2003	31.88	28.22	46.10	31.15	26.03	43.33	32.94	30.27	48.63	0.39	1.20	1.13
2004	31.95	25.73	47.11	30.49	22.36	43.06	33.39	27.70	49.74	0.71	1.19	1.57
2005	29.84	23.99	43.63	28.92	21.95	42.17	30.65	25.41	45.42	0.45	0.84	0.69
2006*	28.62	23.75	41.64	28.33	23.01	40.81	29.14	24.59	42.39	0.19	0.29	0.35

* as of 21-April, 2006

CZK → EUR ~2013

The Czech National Bank [CNB] recently estimated that the Czechs will join Euro, adopting the Euro single currency, in 2013 at exchange rate of 25.50 CZK/EUR. As of October 2005, the Czech crown is currently trading at 29.70 CZK/EUR. The government cabinet has consistently indicated plans to adopt the euro in 2010.

From the countries of the Visegrad Four (V4), the Czech Republic, Slovakia, Poland and Hungary, Slovakia are the closest to euro adoption and the Czechs' plan to join in January 2009 appears quite realistic. The remaining three V4 members will join the euro only in the second decade of the 21st century. We expect that central European currencies will firm prior to the adoption of the euro, possibly by 2-4% p.a. if current trends persist.

Czechs in general mainly favour adoption of the euro. While average support of a single European currency within the EU amounts to 59%, 63% of the Czech Republic supports it. Another study showed that while smaller countries within the new group of EU member states—such as Slovenia, Lithuania, Estonia and Cyprus—are cruising toward euro adoption, the road for bigger states—Poland, the Czech Republic and Hungary—is full of obstacles.

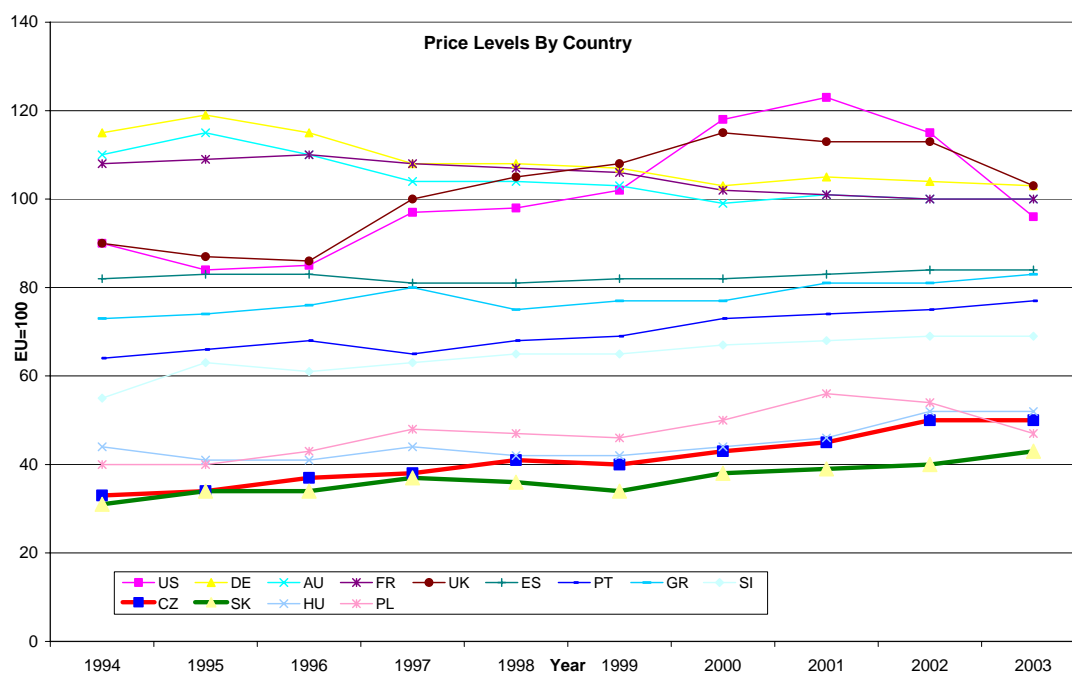
Why the Czech Crown Should Appreciate

The price parities between the Czech Republic and its close EU neighbours still show a huge gap as in purchasing power. One year after the Czech Republic entered the EU on 1-May-2004, there are still strong natural economic pressures on prices in the Czech Republic to align with those of its neighbouring countries whose more expensive goods would then flow freely and without restriction across borders. Currently the price levels in the Czech Republic after conversion using the foreign currency exchange rate represents approximately 47 % of the average EU price level.

There are essentially two ways the prices of Czech goods can align with its neighbours: 1) Inflation, 2) Currency Revaluation.

The effects of allowing inflation to adjust the prices would be devastating to the Czech economy. The government, as it has in the past, will likely fight inflation with every tool in its box to keep it under control. Hence, this will most likely not be the mechanism for which prices will align.

This leaves currency revaluation as the only viable option. Letting the currency appreciate against Euro would allow the “price” of similar goods to align without dramatically raising the nominal prices of goods on the domestic market. There are of course drawbacks to a currency that is too strong, but the benefits overall far outweigh the severe negative effects the only other option, inflation.



Source: Czech National Bank (July 2003)

It can be assumed that until the point of membership of the Czech Republic in the European Monetary Union [EMU] it would be desirable to have the inflation rate in

the Czech Republic slightly higher (approximately by 1 - 2 percentage points) when compared to the EU average and the EMU average. This development should be accompanied by a gradual, long-term strengthening of the CZK/EUR exchange rate (in the extent of 2–3% annually). Following this direction would result in the price level in the Czech Republic equalling approximately 70% of the EU average.

The approximate value of the Czech Crown vs. the Euro or the US Dollar as of the writing of this section of our report (21-October 2005) is 29.8 CZK/EUR and 24.8 CZK/USD. This is considered by most analysts (including myself) as a strong valuation. There is, however, a great deal room for further appreciation and it is widely believed that the Crown will reach 22-24 CZK/EUR.

Hedging Strategies

In the event of CZK exchange rate volatility, a strategy of pricing rents into the EUR equivalent would likely be taken. This is practiced widely by lessors of office space and also of some housing developers who have most of their debt financing denominated in EUR. However, in the recent past, the CZK's consistent strength and stability vs. the EUR has caused many landlords to reassess the logic of basing their rents on foreign currencies.

Budget Deficit

As of October 2005, the Czech Central Bank sees the 2005 budget gap much lower than planned. The state budget should post a much lower gap than previously projected. The budget is in the black and there are hints that the public finance gap could decline to 3% of GDP, a limit set by the Maastricht criteria for euro adoption. The government originally pledged to keep the fiscal gap at 4.7% of GDP at for most of this year.

The budget deficit stands at CZK 74.4 billion. Revenues are put at CZK 884.4 billion and spending at CZK 958.8 billion. Mandatory spending of the state budget is put at CZK 508 billion, making up 53% of all spending. Social expenditures are the biggest part of mandatory spending, up 6.6% on the year. The budget counts on an old-age pension rise by 4.9% or CZK 380 on average.

The state budget surplus now reaches almost CZK 26 billion driven mainly by higher tax revenues. The deficit projected for this year amounts to CZK 83.6 billion.

In evaluating the situation, one will have to watch also other channels where government money flows. The public budget deficit and public debt offer a worse picture.

Current-Account

The Czech current-account deficit fell to CZK 8.991 billion in August 2005, down from July's CZK 10.466 billion, influenced by the gap in the trade and income balances. Economists were surprised by the result. The market had expected a gap of around CZK 11 billion. We are of the opinion that overall, the result can be viewed as favourable, and the lower deficit should have a positive influence on the crown in spite of our long-running observations where heavier deficits in the past failed to correlate with a weaker crown.

The trade balance and income balance ended with a CZK 1.9 billion and a CZK 8.3 billion deficit, respectively. The trade balance includes the import of fighter aircraft

worth CZK 5.9 billion. Without the import of the aircraft, the current account would show a surplus of around CZK 3.1 billion. The income balance deficit was due to the payment of dividends and the estimated reinvested direct investment earnings. The balance of services showed a CZK 1.4 billion surplus.

The balance of current transfers includes a deficit of CZK 0.6 billion on transfers from the Czech Republic to the EU budget. The capital account includes a surplus of CZK 0.2 billion on transfers from the EU budget. The annual current account total has been showing a gradual decline in deficit since September 2004 according to the CNB.

Capital inflow on the financial account was CZK 11.9 billion under European Central Bank (ECB) methodology. Direct investment recorded a surplus of CZK 7 billion, of which estimated reinvested earnings were roughly CZK 6.5 billion.

The portfolio investment inflow of CZK 0.4 billion was mostly due to bond purchases by non-residents and a foreign bond issued by a domestic private entity.

Direct investment showed a high annual inflow thanks to privatisation receipts. As regards portfolio investments, the annual total inflow of funds from abroad had been gradually declining and turned into an outflow in June.

Other investment showed a surplus of CZK 9.3 billion. The government sector includes the drawing on a loan for the lease of fighter aircraft and transactions related to unblocking of government credits. The CNB's international reserves adjusted for valuation changes rose by around CZK 1.2 billion.

State Debt

Czech debt grew by CZK 19 billion to CZK 662.6 billion in Q3-2005, while in Q2 it stood at CZK 643.6 billion, according to the finance ministry. The debt now totals almost CZK 65,000 per capita. The state debt to GDP ratio rose from 22.8% to 23.1%. State debt will likely rise by CZK 90 billion this year and top CZK 680 billion, or 23.6% of GDP.

The government also holds guarantees worth CZK 95.6 billion, of which CZK 26 billion is payable within a year. Uncertainty still prevails over the intentions of the government, the finance ministry and the Czech National Bank (CNB) about an early payment of a guarantee to the CNB worth CZK 22 billion. Two-thirds of the amount could be paid this year and the rest in mid-2006.

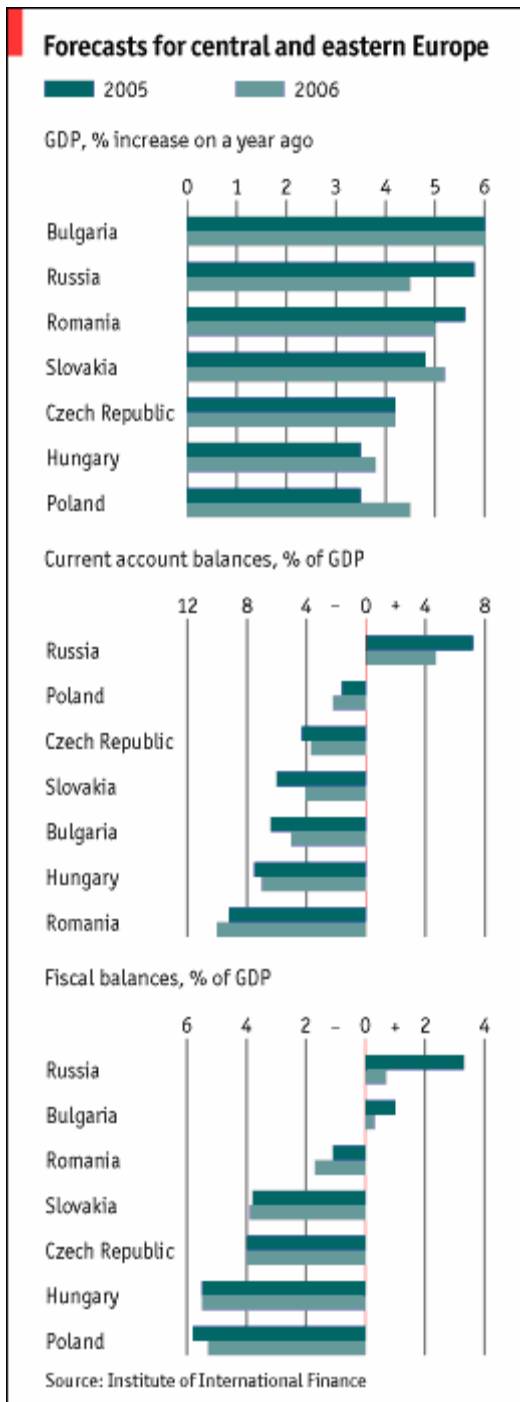
From July-September, the government borrowed another CZK 2.2 billion from abroad, raising the debt to CZK 7.7 billion, or 65% of the amount planned for the whole year. State bonds worth CZK 27.8 billion were issued in the third quarter, raising the amount to CZK 81.6 billion for the first nine months of 2005, and representing 68% of the plan for the full year.

In the third quarter, the volume of treasury bills further decreased, and the drawing of loans from the European Investment Bank increased.

The share of short-term debt has decreased from 25 to 21.7% in Q2 and to 19.4% in Q3. The average maturity of the Czech state debt has remained the same as for Q2 at 5.8 years.

Regional Comparisons of Key Economic Figures

Many economies in central and Eastern Europe will see slower growth this year thanks to weaker foreign demand and stronger currencies. For example, Romania's economy is expected to slow sharply, from 8.3% in 2004 to 5.6% in 2005. Economic growth in Poland and Hungary has marginally picked up in the second half of 2005, but in the Czech Republic output has been buoyed by strong inflows of foreign direct investment and the Czech economy will expand at almost four times the pace of the euro region as consumers and companies spend more.



Poland's economy will grow 3.8% in 2005, accelerating from an annual 2.1% in the first quarter. Hungary's gross domestic product will rise 3.5% this year from 2.9% in the first three months in comparison with solid Czech annual growth sitting at 4.4% throughout the year.

The combined \$470 billion economy of the three eastern European nations, making up 80% of the total GDP of the 10 states that joined the European Union last year, is underpinned by investments from companies including carmakers Toyota Motor Corp. and PSA Peugeot Citroen and builder Skanska AB. Consumer spending has been bolstered by soaring wages following EU entry.

Fast growth is proof that EU enlargement is a success story. Western Europe tends to look at new member countries as poor cousins, but the growth rate proves they really are European tigers. As of June 2005, the 12-nation euro economy looks set to expand only 1.2% this year, slowing from its relatively sluggish 1.9% last year.

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Business, Industry and Consumer Confidence

Confidence in the Czech economy fluctuates as it does in just about any country (except maybe places like Cuba). Overall confidence in the Czech economy dropped in August 2005 but remains high in general, according to the Czech Statistical Office.

We hold the view that the economy is clearly stabilised. If the Czech Republic does not suffer a remarkable external shock, such as a drop in export demand due to high oil prices, it should retain its healthy growth pace above 4%. We see the drop in consumer confidence as a short-term reaction to news of an expected growth in energy prices, excise tax, and perhaps also high oil prices raising the standard concerns as winter approaches.

Business and consumer confidence decreased month-on-month in August. Against August 2004, overall confidence and business confidence fell, while consumer

confidence was higher. The share of consumers who expect unemployment to grow and who want to save grew in August against July 2005.

Confidence in the industry dropped both month-on-month and year-on-year. In the building sector, confidence stayed the same, while retailers and services showed higher confidence. One in three industrial companies said they expected output to grow in the next three months, while almost 7% said they expected a decrease. Industrial companies also expect to employ more people. In the next six months, they expect a favourable economic situation.

On the other hand, building companies expect employment to drop in the next three months. Two in three said they expected their economic situation to stay the same in the next six months, while one in five predict an improvement.

Retailers' confidence stayed much the same as in the previous month. Some 53.7% of respondents said the economic situation in retail corresponded to the season, while more than four in ten retailers said the situation was good. More than one-third of retailers said they expected an improvement in the next six months, while six in ten predict the situation will stay the same. Most said prices should not change much.

Some 58.1% of respondents in services said the situation in the segment was good, while 1.5% said it was bad. More than 60% said demand should not change in the next few months.

Most entrepreneurs in services predict prices will stay at the present level. Some 65% said employment in the segment would not change, while 25.6% expect workforce to drop.

The Effects of EU Entry

So far our verdict stands that Czech EU entry pays off for now. In spite of a highly vocal anti-EU president, the Czech Republic's accession to the European Union last May has paid off for now. On the positive side, there is a steep acceleration of Czech foreign trade due to the traditionally high degree of openness in the Czech economy and the removal of customs duties and other administrative barriers. Moreover, the Czech Republic has received CZK 36 billion worth of EU money and contributed CZK 29.1 billion to the EU budget.

A 10% growth in industrial production last year produced the only one real negative factor which has been a mounting environmental burden stemming from higher truck traffic volumes. This is clearly visible to anyone who routinely makes the journey from Prague to Brno. Truck traffic has been exacerbated by an oversight in Czech tax law that makes Czech roads cheaper to cross than its neighbours and the Czech Republic is bound by EU law not to increase its road taxes in response. In spite of higher truck volumes it has been reported that EU entry has diminished prostitution in border areas—shorter waiting times at crossings have meant that truckers, once steadfast customers, have less time to spare when processing their loads. We at PIP do not count this as negative factor number two.

Compared with countries which joined the EU in the 1980s and 1990s, Czech exports are growing at a much faster pace. In spite of the traditional farmers' protests, trade in agricultural products even showed positive results. In fact, the nation's trade balance has improved by CZK 78.5 billion since last May 2004. Exports grew by 23.8% and imports by 17.5%.

Fears of a negative impact from EU entry on financial stability proved groundless. Price hikes stemming from shifting some items under the 19% VAT had no major impact on inflation. Competition between big retail chains keeps food prices at low levels. The large grain harvest last year also played a role.

Consumer inflation remains at a level lower than that in the EU as a whole. Inflation in the EU-25 grew by 2.1% in April 2005 year-on-year, while in the Czech Republic it was 1.4%.

The EU entry had no effect on the country's budget stability either. A steep fall of the Czech budget deficit to 3% of GDP was caused above all by new budget rules. Also, the EU accession had no impact on the fact that tax revenues have actually grown by 9%.

Fears of lower living standards after EU entry were not fulfilled either. Three months before the entry, almost half of the population feared its standard of living might decrease, but one year after entry, only 15% of people complain that their economic situation has worsened. Two-thirds of those polled said they think their standard of living has not changed, 5% think their living standard has improved and 5% said they did not know. More than two-thirds of Czechs said the EU entry had an adverse effect on energy prices and half of the population complains that public transport and food prices have increased.

The supply of goods and services on the Czech market has been evaluated very positively and people also appreciate the impact of the country's EU entry on the crown's rate and the banking sector. Surveys show that the EU entry negatively affected Czech industrial enterprises, small and mid-sized businesses and farmers, though we've failed to see this view backed statistically. There was also a negative evaluation of the Czech health sector and education.

Czechs also frequently answer that the country's accession to the EU had neither a favourable nor an unfavourable impact on each particular sphere.

Some 52% of Czechs said the Czech Republic should adopt the euro, 37% were against the euro adoption and a tenth of the population is undecided. Young people who are satisfied with the EU entry, and voters of the ruling CSSD and senior opposition ODS were among those who expressed their approval of the euro adoption. Older people who vote Communists KSCM are against adopting the single currency.

Foreign investment

A recent survey by consulting company Ernst & Young revealed that investors regard the Czech Republic as the seventh most attractive country in the world. The numbers tend to agree as foreign direct investment (FDI) in the Czech Republic will amount to a record CZK 220 billion this year against CZK 114.7 billion last year, according to estimates by the government agency CzechInvest and the Czech National Bank. Between January and August 2005, foreign companies invested nearly CZK 190 billion in the Czech Republic. Expressed in dollars, this year's investment inflow could be the highest in the history of the Czech Republic [since 1993].

Privatisation proceeds, especially revenues from the sale of Cesky Telecom and Unipetrol, will account for more than a third of the total sum. The largest investment project this year is that of Japanese company Daikin, which plans to spend almost CZK 3.8 billion on compressor production in Brno.

The Czech Republic is increasingly attractive especially to projects involving technology centres and strategic services enabling firms to provide legal, financial and consulting services to the whole of Europe from one place. Foreign companies are lured to the Czech Republic by a relatively cheap but skilled workforce, affordable real estate, location close to lucrative western European markets and the growing prosperity of the country.

Czech Taxation

The Czech Republic has above-average taxes in the EU on labour and capital, while its excise duties are lower than average, according to a new Eurostat report on EU taxes in 2003. The study showed that in Slovakia, all types of taxes are lower than the EU average.

The overall tax burden stands at 36.2 percent of GDP in the Czech Republic and at 30.6 percent of GDP in Slovakia. Compared with the EU average at 40.3 percent of GDP, taxes in both countries are low at first sight.

The EC has decided to compare also effective tax rates, which take into account all deductibles and exceptions and show what share of their income people and companies really pay in taxes.

The result was that the tax burden on work in the EU stands at 35.9 percent on average, while in the Czech Republic it is 40.1 percent.

Tax on capital of Czech companies and individuals stands at 27 percent against 25.4 percent in the EU. Taxes on capital had also been rising until 2000, but then they began to fall again. In contrast, Czechs pay 20.5 percent in excise duties, while the EU average is 22 percent. Despite a recent moderate fall in rates, all of Europe has to grapple with high taxes on labour.

Statistics from the last few years also show that in new EU member countries, tax revenues to the state coffers grow when tax rates fall. However, it cannot be said whether the higher budget revenues can be ascribed to the fall in taxes and the willingness of companies to pay them. This can also be thanks to growing investments into these countries and a faster growth of their economies.

Czech Labour Market

Unemployment

Unemployment fell to 8.8% of the economically active population in the Czech Republic in September 2005, in line with expectations of the ministry of labour and social affairs.

In September 2005, the number of job seekers was 503,396. Conditions on the labour market have improved compared with last September 2004, as the number of job seekers dropped by 26,843. According to government sources 474,964 Czechs are ready to take a job immediately, with the remaining 28,432 being prisoners, or women on maternity leave, for instance. Employment offices registered 272,165 women, or 54.1% of all people out of work, and 74,258 handicapped people, or 14.8% of the total. Women accounted for 10.9% of the unemployed, men made up 7.2%. School graduates and young people made up 9.4% of all unemployed, with employment offices registering 47,094.

There were 55,798 vacancies, 3,498 fewer on the month and a rise of 8,694 on the year.

Unemployment in the regions, however, still varies greatly. In Prague and its outlying neighbourhoods the rate of unemployment is traditionally below 4%.

In September 2005, Prague-west reported 2.8-percent unemployment, in Prague itself it was 3.6%, in Prague- east 3.1% and in Mlada Boleslav in Central Bohemia 3.9%.

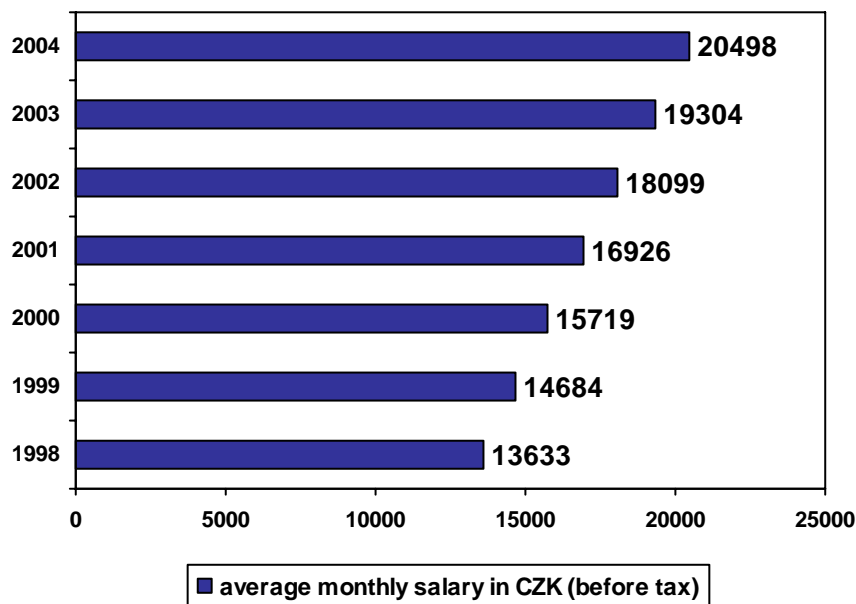
Unemployment in the Most region in northern Bohemia stood at some 22%. It is hard to find work also in Karvina region in northern Moravia, in Teplice and Chomutov in northern Bohemia. There are 9 job seekers per vacancy on average nowadays, while in Karvina it is almost 71 job seekers.

The EU average unemployment rate, used by the EU statistical office Eurostat for international comparison, stood at 7.7% in the Czech Republic in August 2005, while in 25 EU countries it was an average 8.6%.

Unemployment higher than in the Czech Republic was reported in Belgium, Germany, Greece, Spain, France, Latvia, Poland and Slovakia.

Wage Levels

According to PricewaterhouseCoopers' annual Pay Well salary survey, salaries continue to rise steadily, although the growth has dropped slightly. In the survey years (measured from July to June) between 2002-04, the real increase of wages was 6.9%, 6.3% and 5.6%, respectively. For the last survey period (ending June 2004), the largest raises went to employees in construction and banking.



Wage Levels by Job Sectors

While banks have traditionally paid well - Komerční banka and ČSOB, with average salaries of CZK 33,800 and CZK 31,500, were among the top six best-paying employers in a general survey (conducted in October 2004) by Mladá fronta Dnes - construction companies are increasingly upping their compensation levels, backed by a continued boom in building. Larger increases should continue, if major constructions companies like Skanska and Metrostav are any indicator. Also in MfD's

survey, these two firms report planned pay raises between 6-7% in 2005. On average, companies taking part in the PwC's survey - 112 mostly large, international companies across most sectors of the economy - plan to increase salaries by 5.2% this year, about twice as much as the current inflation rate. Besides banks and telecoms - Oskar, with an average salary of nearly CZK 50,000, topped MfD's best-paying employer list - the pharmaceutical sector is one area with salaries usually a fifth higher than average, according to various surveys. The discrepancies between sectors is shrinking, though.

The number of new IT projects - DHL chief among them - in Prague, as well as Brno, has caused a labour shortage in the sector, creating a candidates' market. Part of the reason is DHL's new European IT service centre, which started in Prague last September. Once the project is finished, 1,000 IT positions will be filled. The project is putting a big strain on the job market, and consultants note that companies are losing employees to DHL. IT salaries remain high with project managers or IT managers, for example, earning between CZK 60,000 and CZK 100,000 or more.

Multinational companies pay between 35%-58% more than Czech firms at the middle and top management level. At about the same level are regional differences between salaries in Prague and the rest of the country. The highest difference is in salaries of financial managers, which can reach 60%, average for all positions is about 30%. The lowest differences are for sales representatives and in quality control. Significant differences can be found among managers and directors. Eight years ago, the difference among the average monthly salaries of department managers was CZK 20,000 maximum, now it is about CZK 50,000.

In 1996, the losers were HR directors, while the winners were sales directors. The latter have stayed at the top, earning 10% more than a financial director; technical directors now have the lowest salaries among management. Other supporting managers - like HR and marketing - are also slightly below sales and finance managers.

Employers are also getting more sophisticated in terms of paying out bonuses. The year-to-year increase in salary is becoming lower, while companies tend to motivate employees by improved bonus systems. The typical 13th salary is becoming a thing of the past, with PwC reporting its use in only 40% of companies. Most companies are now working with performance-based awards. But, a lot of companies have needed to improve their system where has been mismanaged. Typical problems are found in non-transparent "profit sharing schemes" that can be easily manipulated with accounting methods. Though bonus proportions are still a smaller part of salaries, money is tied much more to performance now.

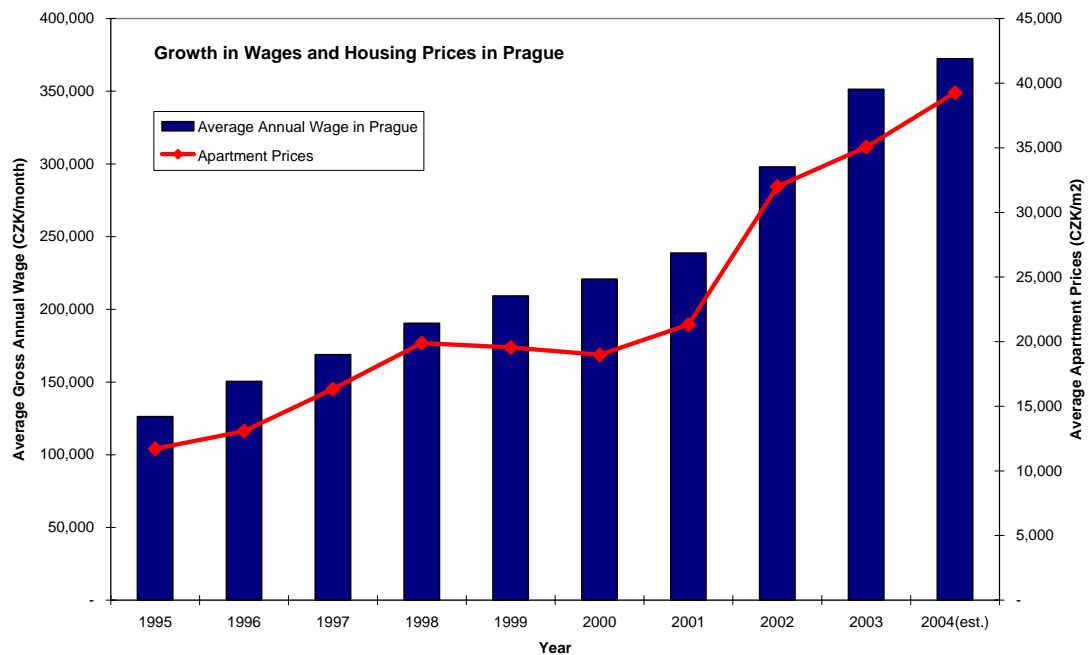
As of September 2005, employment in construction enterprises with 20+ employees grew by 5.1% on the year. The average monthly wage of the employees increased by 6.8% year-on-year and reached CZK 19,083, 5.0% in real wage terms. The average hourly wage increased by 2.5% and stood at CZK 123. Labour productivity per employee went up by 1.1% and labour productivity per hour worked fell by 3.4%. Unit wage costs rose by 5.7%.

Benefits

Benefits are becoming a big issue. Employees are not looking for average benefits and many benefits are taken for granted; some are seen as givens. These include meal allowances and working tools like a car, notebook, or telephone. At a management

level, a telephone isn't even a benefit anymore, underlining the "routine" aspect of this one-time extra.

Benefits which bring a tax advantage are also common now. However, benefits that relate to real estate such as supplements toward housing are not common for locals, because they are taxed virtually at the same rate as cash. Furthermore, transactions that could appear to be paid housing are often scrutinised by the financial authorities, so again there is little incentive for firms to push "grey areas". Housing allowances for foreign nationals seconded from abroad are still abundant; particularly where the cost can be allocated to a non-socially taxed area. In the field of manufacturing, some manufacturing companies are providing housing allowances and are very successful with this when quality people need to be drawn into more rural regions; particularly away from Prague.



Source: CSU & Property In Prague, 2004

Base salary for selected positions

Plus, analysis of apartment affordability.

AVERAGE GROSS MONTHLY SALARIES IN PRAGUE (CZK)				AFFORDABILITY			
Position	Quartile***			Price Range for Flats (CZK) (1)		Monthly Mortgage Payment (CZK) (2)	
	Lower	Median	Upper	From	To	From	To
Head of Sales and Marketing	128,000	158,000	220,000	13,363,200	15,048,000	44,248	49,827
Marketing Manager *	79,000	93,000	118,000	8,247,600	8,071,200	27,309	26,725
Sales Manager *	70,000	84,000	96,000	7,308,000	6,566,400	24,198	21,743
Finance Manager *	47,000	77,000	103,000	4,906,800	7,045,200	16,247	23,328
Key Account Manager	58,000	67,600	80,000	6,055,200	5,472,000	20,050	18,119
HR Manager *	41,000	61,000	92,000	4,280,400	6,292,800	14,173	20,837
Production Manager *	33,000	46,000	62,000	3,445,200	4,240,800	11,408	14,042
Brand Manager	34,600	39,800	50,300	3,612,240	3,440,520	11,961	11,392
Senior Accountant	28,400	37,000	46,200	2,964,960	3,160,080	9,818	10,464
Analyst Programmer	25,300	34,000	43,200	2,641,320	2,954,880	8,746	9,784
Production Line Supervisor	25,000	30,000	34,700	2,610,000	2,373,480	8,642	7,859
Market Analyst	24,000	29,000	32,500	2,505,600	2,223,000	8,297	7,361
Network Administrator	21,200	26,400	30,000	2,213,280	2,052,000	7,329	6,795
Personal Administration Officer	21,400	24,800	29,700	2,234,160	2,031,480	7,398	6,727
Warehouse Supervisor	21,700	24,200	30,300	2,265,480	2,072,520	7,501	6,863
Accountant	19,700	23,800	29,000	2,056,680	1,983,600	6,810	6,568
Process Engineer	20,700	23,800	26,100	2,161,080	1,785,240	7,156	5,911
Sales Representative **	14,100	20,800	23,900	1,472,040	1,634,760	4,874	5,413
Secretary	15,800	19,000	21,500	1,649,520	1,470,600	5,462	4,869
AVERAGE	38,311	48,379	61,495	3,999,619	4,206,240	13,244	13,928
Median	25,300	34,000	43,200	2,641,320	2,954,880	8,746	9,784
Min	14,100	19,000	21,500	1,472,040	1,470,600	4,874	4,869
Max	128,000	158,000	220,000	13,363,200	15,048,000	44,248	49,827

(1) Based on a Price to Income Ratio of 8.7 (Average for Prague in 2004)

(2) Based on a LTV Ratio of 70%, amortised over 25 years @ 3% annual interest

* these positions report to the head of the respective department

** another cca 30% of salary is in the form of variable pay or sales incentives; variable part for other positions is significantly lower

*** quartiles are dividing the observations into four equally sized files, e.g. within the lower quartile lies the lowest 25%, above it is the rest; with the median dividing the file into two equal parts

Source: Total Remuneration Survey (TRS) 2004, Mercer Human Resource Consulting, a.s., Borrowing potential based on salaries calculated by Erik Dempsey, Property in Prague

Minimum Wage

The minimum wage in the Czech Republic will grow by 6.6 percent as of January 2006. People who receive the minimum wage will have CZK 7,660 a month, compared to the current CZK 7,185, and the minimum hourly pay is to grow by CZK 2.70 to CZK 45.20.

The government plans further increases in July 2006 when the minimum wage is to grow by 6.2 percent. After the second increase, the minimum wage is to reach CZK 8,135 and the hourly wage CZK 49.20.

Purchasing Power

In Comparison to the EU

The purchasing power in the Czech Republic is one of the highest among the EU newcomer states, according to a study by UBS bank. The purchasing power parity of Czechs equals some 66% of the EU-15 average. The value is lower than in Slovenia with 74% but higher than in Hungary (59%), Slovakia (49%) and Poland (45%).

Prague ranked 46th among 71 of the world's capitals included in the study. Of the other new EU members, only Ljubljana, Slovenia ranked higher while Slovak capital Bratislava placed 52nd.

UBS considered the length of time the inhabitants in the individual countries have to work to be able to buy the Big Mac hamburger to compare the countries' purchasing power.

While it takes people in Prague 40 minutes on average, employees in Warsaw, Poland and Budapest, Hungary work two minutes more. Slovaks have to work 51 minutes to buy the Big Mac.

Prague is very cheap compared with the other capitals and prices are lower only in 12 out of the 71 monitored cities. Budapest, Warsaw and Bratislava are more expensive than the Czech capital.

Still, people in Prague earn less than the inhabitants of Warsaw and Budapest, ranking 51st in the study's wages list.

Regional Purchasing Power

In a September 2005 poll by Incoma Research and GfK Praha has shown. The purchasing power of Czechs living in Prague exceeds the national average by 33%, while that of residents of some regions in Moravia is significantly below the national average,

The purchasing power per capita in Prague equals nearly 133% of the national average. In contrast, the average value of the purchasing power index is below 70% in dozens of other towns and villages.

Regions where people's purchasing power exceeds the country's average include Karlovy Vary, Brno, Plzen, Liberec and Central Bohemia. In contrast, the value of the index reaches only 90.3% in the Vysocina region.

Modern shopping malls serve as an indicator of purchasing power. At the end of 2004, Prague's modern shopping complexes occupied an area of 400,000 square metres, with some 339 square metres of retail area per 1,000 inhabitants. But in the Vysocina region, there was not a single shopping centre of this kind.

Slovaks most, Czechs least threatened with poverty

According to recent study by the OECD only 4% of Czechs live below the official poverty threshold. This ranks the Czech Republic as the country with the lowest number of poor relative to the general standard of living in the whole organisation, which includes nearly all developed countries. Only Denmark and Sweden come close to the Czech figures. In the Czech Republic poverty technically affects people with a monthly net income of under CZK 7,000. The Czech pension system is the most egalitarian. Reportedly all Czech pensioners reach about CZK 7,000.

The Czech welfare system is also considered the most efficient - on a par with the Scandinavian countries, although at a far lower cost. The pension system in the Czech Republic is set up in such a way that nobody in the retirement age should be below the poverty line. Second, there is the minimal acceptable social income, so even single headed families with children shouldn't be below the poverty line. Thirdly, Czechs have a very cheap health care system. There are virtually no patient co-payments. So these three factors, we believe, contribute to the low problem of poverty.

We believe the factor that contributes to the "good social situation" in the Czech Republic is the tradition from the socialist regime. The Czechs inherited the system with a very low degree of inequality and that has been maintained until today, to a large extent. During the transformation period the Czechs never had any radical reform, and there was never any large-scale dismantling of the welfare state. Even the so called right wing governments in the first half of the 1990's never really did much to reduce the benefits. And that tradition goes on till today. Hence, the real estate market is still burdened with the issues of regulated housing. Furthermore, the high cost of social taxes makes hiring and paying employees "above the table" unattractive. This is major reason behind the large "grey economy".

In contrast to their close counterparts in the Czech Republic, people in Slovakia are the most threatened with poverty in the European Union, with 21% of them earning dangerously low incomes, according to Eurostat.

In calculating the poverty level, Eurostat uses the median, or wage earned by exactly half of the country's population. Poverty begins below 60% of that amount, according to Eurostat.

Some 72 million people were threatened with poverty in the entire EU in 2003. Statistics confirm that poverty in the EU is significantly reduced by the payment of all kinds of social allowances. Without them, some 40% of Czechs, 40% of EU citizens, and some 50% of Poles, would live in poverty.

Job Creation

The Czech Republic largely lost its lustre for foreign companies looking to open production plants because of increased production and labour costs (largely due to absurdly high social/employment taxes). Instead, investors are now keen to take advantage of qualified people and move their shared services centres to the country. Those with specialized qualifications, such as information technology engineers and accountants, for example, are considered comparable to their western counterparts and much cheaper—and the investment du jour is for shared service centres, namely financial, accounting, human resources, information technology and customer service centres.

Although Prague and the country have proved alluring for major multinationals, the lack of some basic skills has proved to be a burning issue, as most companies that have opened shared service centres here have announced further expansions and will multiply the number of employees.

Foreign investors have voiced concerns about the professional skills of the locals they hire to work at the country's growing number of shared service centres, often finding that Czech workers are lagging in so-called soft skills, including the ability to communicate, work well in a team and negotiate effectively. Foreign-language

proficiency and information technology qualifications have also been cited as deficiencies.

Skilled Labour Employment Levels below EU average

Employment levels in the highly skilled professions here is lower than the EU average, according to documents from the European Union Council. Highly skilled professions account for only 34% of those employed, which is the 15th-highest figure in the EU, ahead of Austria, Spain and Italy. Low-skilled employees make up 45% of those employed here. Topping the EU list are Sweden, Finland, Denmark and the Netherlands, at 40% or more of the workforce in the highly skilled category. The need for more workers to fill highly skilled jobs such as those in electronics, communications, digitalization and financial services is growing within the 25-member bloc.

These statistics indicate the Czech Republic's high capacity for accommodating a large influx of multinational companies demanding high technical ability within their local work staff.

Foreign IT investment

The amount of foreign investment in the Czech Republic's information technology sector is rising as the world's largest IT companies build their development and customer service centres in the country. Common reasons typically cited are of course that the Czech Republic is attractive mainly for its location in the centre of the continent, its cheap workforce and a well-developed infrastructure.

The world's largest computer producer, *Dell Computer*, wants to build a plant in Central Europe to supply computer technology to the whole of Europe and Africa. Only the Czech Republic and Poland now remain on the shortlist as of October 2005. According to some industry sources, Dell will build a logistics centre near Prague's Ruzyně airport to manage deliveries to the whole region.

Oracle, the second largest software producer in the world, also announced in October 2005 that it was opening a sales-support centre in Prague. The centre now employs 40 people, a number set to increase. The centre employees will cover the whole of eastern Europe, the Balkan countries and Turkey.

Oracle's biggest rival, the German company *SAP*, entered the country in September 2005, opening the world's largest shared services centre in Prague. Staff numbers in the centre should double in two years from the current 150. The centre will provide services to other branches in Europe, the Middle East and Africa.

US company *Computer Associates*, the fifth largest software maker in the world, has been probably the largest investor in the Czech Republic this year. In August 2005 it opened a development centre in Prague worth CZK 1.1 billion. The centre with some 200 employees is focused on global software development.

One of Dell's biggest competitors, the Taiwanese firm *Acer*, opened a servicing centre in Brno in August 2005.

DHL, the world's largest logistics firm, announced the opening of its CZK 5.75 billion (~EUR 190 million) IT headquarters in Prague in October 2003. Currently the centre employs over 500 people, but by the end of 2006 it should employ more than 1,000. The company also relies on a fairly strong base of expatriates to introduce new local candidates to the position and share their experiences with them.

Other Recent Major Multinational Movements

ExxonMobil around the same time announced it was opening a “centre for strategic services” in Prague in July 2004. The centre will eventually employ 300 people and provide customer service, IT and accounting services for the company’s branches worldwide. Company representatives said they’d like to expand if the Prague centre is successful.

Global consulting giant *Accenture* entered the Czech market in October 2001 and in October 2003 the firm announced it was expanding its centre. By 2008 the consulting firm should employ about 1,500 people here and will have invested about CZK 169 million in the centre. Currently there are about 500 employees, of which about 130 have a university degree.

The new € 650 million (CZK 19.4 billion) *Toyota Peugeot Citroen Automobile (TPCA)* car assembly plant near Kolín. The state promised to build 850 apartments for TPCA workers, but so far only 137 apartments, at a cost of about CZK 100 million, in a reconstructed army barracks are available. In August 2005, 154 more apartments should be ready. But it is not known when the remaining 565 apartments at a greenfield site called U vodárny (At the Waterworks) will be built. The TPCA housing situation:

- Apartments available for workers: 137
- Apartments under construction: 154
- Apartments promised on paper: 565
- Deadline for the government to complete the TPCA housing: none
- Total expected housing budget: CZK 412 million

Daido Metal is another Japanese investment attracted to Brno. One of the most significant global manufacturers of bearings, Daido Metal, has chosen the city of Brno and its Cernovicka Terasa industrial zone as the site for its new plant. The land purchase agreement has already been signed. The investment will reach almost CZK 400 million and in the first phase the plant will hire up to 100 people. Production should be launched as early as the beginning of next year.

Daido Metal’s arrival in Brno is proof that the city offers foreign investors a high-quality environment, a well-prepared industrial zone and abundant, qualified human resources.

Foreigners Inbound

Overall, the share of foreigners in the Czech Republic’s labour force has roughly doubled over the past ten years and now stands at over 3%, according to a study by the Labour and Social Affairs Research Institute. The study showed that the majority of people coming from within the EU to seek employment in the Czech Republic are from Slovakia and Poland.

Whereas in 1994 there were 91,000 foreigners working in the country, last year there were 173,000. Ten years ago, foreigners represented less than 2% of the labour force, last year their share grew above 3%. In 2004, 108,000 foreigners were employees and 65,000 foreigners were entrepreneurs.

Although half of all foreign workers are EU citizens, with the exception of Germans, citizens of economically more developed EU member states are not particularly drawn to earn their living in the Czech Republic.

A third of foreign workers are from European states outside the EU, mainly from Ukraine. 16% of foreign workers are from Asia, mainly Vietnam.

Foreigners make up 11% of the work force in and around Mlada Boleslav, home of car-maker Skoda, and 8.3% in Prague. Foreigners had the lowest share of the labour force, around half a percent, in Bruntal and Opava, both in north Moravia.

Over the past ten years, the number of foreign entrepreneurs possessing business licences grew faster than the number of foreign employees. Whereas an employee work permit is tied to a particular location, permits regulating business are more flexible. However, relatively few of the Slovaks making a living in the Czech Republic have a business licence and most of them prefer to be employed. The same applies for other EU citizens. This is likely due to the fact they can get a job without any restrictions.

It was not difficult for people from the older EU member states to obtain a work permit even before Czech accession to the EU because they usually worked in high-skill jobs. On the other hand, the study shows that it is difficult for people from non-EU countries to find high-skill jobs. People from the former Soviet bloc and other countries get lower paid work at lower-skill jobs.

Foreigners work illegally in the Czech Republic in mostly low-skill jobs doing utility work, wash dishes, cleaning work or work in factories, etc. According to estimates based on inspections, there were probably 17,000 illegal labourers in the Czech Republic last year. However, this seems intuitively quite low to us and we think the actual number could be several times higher.

EU entry helped simplify the visa and relocation process for citizens from other member states, also fuelling the demand for international relocation to Prague. The number of people moving into and out of the Czech Republic is on the rise. Likewise, the number of foreigners holding permanent residence permits or having visas valid for more than 90 days rose to 252,120 in 2004 compared with 240,421 a year earlier, according to figures from the Czech Statistical Office (ČSÚ). Of course, only some of these newcomers will be paying the top-dollar prices for housing, but the trend is still apparent.

Average growth in 2004 for incoming and outgoing international moves was around 30%. Movement out of the country was slightly stronger than incoming. Outbound, there was a lot from France, the U.S. and Canada. Inbound, the main groups came from France, the U.K. and the United States.

EU-wide, there is a growing tendency of companies to relocate staff abroad for relatively short periods, such as six months instead of the traditional three-year stint. This is another factor that has fuelled demand for short-term rental contracts. Short-term assignments are more common. In general there are a lot more working couples working in the EU, and if one gets a job abroad it's not really feasible in many cases for the other to follow. Hence, a lesser tendency to buy vs. rent.

Challenges for Czech Labour

Communication Skills

People hired for managerial positions often prove to have an inability to communicate constructively with their employees. Many managers still tend to take criticism personally.

Language skills are generally good with fresh graduates, but problems occur in the ranks of employees working in technical jobs. Employees, namely those without a university degree, can usually speak a foreign language, but insufficiently. They can say what they did during their holidays, but their technical language skills are very poor. Although English is the crucial language, centres for shared services tend to customers worldwide and need employees who speak other languages.

The educational system is far too theoretical and graduates lack practical skills. They have problems with sharing information and working in a team, and they can't stand up for their ideas and defend them, promote their projects and negotiate. Problems also arise with project management. Workers find it difficult to decide how a project will be run and who should do what.

Czechs are Not a Flexible Labour Force

Flexibility of the Czech labour market is on a very low level. Countries with the most flexible labour force in Europe are Slovakia, Denmark and Switzerland, while the Czech Republic has ranked seventh, according to data of the World Bank. Labour force rigidity is important for foreign investors. Analysts and entrepreneurs generally consider the Czech labour market as non-flexible.

We ascribes the phenomenon to unwillingness to move in search of work, insufficient transport services and housing problems due to regulated rents; a problem PIP's associates actively invest into eliminating. Employers are reluctant to hire staff who reluctant to change their profession, undergo retraining or commute to work. We also blame provisions of the Labour Code.

That said, practically the entire Europe has problems with labour market flexibility. The Czech Republic's disadvantage is that it combines the worst from the practice in western Europe, the reality of socialism and traditional sedate lifestyle of Czech households.

An OECD analysis shows that in the Czech Republic, relations between a company and its employees are the least free of all world advanced countries. Regulation on the Czech labour market is much higher than is the average in the 15 old EU members. Being employers ourselves, we would intuitively concur.

Attempts at presenting a new Labour Code have been criticised because employers are convinced that it will not bring freedom to relations between a company and its employees. Just the opposite, in many cases the new proposals would further restrict the freedom of employers to make individualised work contracts with their employees.

Sector Diversification needed

A concentration of investment in one industrial sector could be dangerous. One of the biggest risks is that as the economy becomes more reliant on the automotive sector. Relying on 5% of the population to generate almost 20% of industrial output is a risky

strategy. The economy as a whole will suffer when the industry hits a downturn in the business cycle. The automotive sector is indeed helping the country now. But, this could be a liability in the future.

Diversification in industrial investment is just as important as in financial investment portfolios in protecting against risk. A decline in demand in the European automotive sector would be a big problem for Czech industry and the economy as a whole. GDP, employment levels and even the mighty Czech crown [CZK] would be hit if or when a downturn comes to the automotive sector. Hence, it is important in the long-run to attract broader investment. The concentration in the automotive sector makes the country very sensitive to trends and cycles within one industry.

Improving work force efficiency

The image of Czech workers diligently putting in long hours on the job to the benefit of their employers has long been a vision savoured by managers. Czechs on average spend more hours at work than their neighbours abroad. But all the extra time at the office doesn't necessarily mean those workers get more accomplished.

A study released in late 2004, though, found that the nation's work force is not as productive as it appears. Czechs spend longer doing less than their European counterparts. Employees fritter away time by taking extended cigarette breaks and checking e-mail, among other diversions. Employees in the Czech Republic waste a third of the time they spend on the job, according to another study conducted by Czipin & Proudfoot Consulting. That adds up to a loss of 103 working days annually, according to the study. The European average is 87 days.

In spite of this, worker productivity has continued to increase despite the high level of lost time, according to the research. Czech productivity levels are equal to the worldwide average of 62%. The productivity level in the Czech Republic is significantly higher than other countries in Central and Eastern Europe and has reached a level which is only 2% lower than in Germany and the United States. While 62% productivity is the world average, it's still far lower than what the consultancy believes to be the optimum productivity level of 85%.

While workers often get a bad rap, responsibility for a company's productivity rests squarely with its managers. A number of companies have already changed their management structures to improve productivity. Professional managers and human resources specialists have been brought in to replace the first wave of post-communism managers.

The fact that Czechs waste more time on the job than other European workers is unlikely to scare away many foreign companies considering setting up shop here. The country remains attractive due to a combination of a skilled work force and a lower wage scale, which means many international companies can set up manufacturing centres in the heart of Europe while still managing to reduce their overhead.

Time spent at work

(hours/year):

- Czechs: 1,906
- Germans: 1,444
- Hungarians: 1,777

Productivity:

- Czechs: 62%
- Germans: 64%
- Hungarians: 59%
- Worldwide average: 62%

Lost time (days/year):

- Czechs: 103
- Germans: 74
- Hungarians: 104
- Worldwide average: 85

Source: Czipin & Proudfoot Consulting

There are also signs that foreign companies have been successful at matching or even exceeding the productivity levels they enjoyed at home by retraining the work force.

Passing the burden of sickness absence

At an average of 29 days per year, the Czech Republic has one of the highest rates of absenteeism in the EU. Numerous studies, have shown that absenteeism has a direct impact on productivity and profitability. Organisations with fewer than 5 absence days per year are an average of 60% more profitable than those organisations with greater than 10 absence days per year.

In a proposed move to incentivise employers to actively reduce their absence rates, the burden of sickness pay could move from the state to the employer whereby employers would be required to pay benefits to employees during the first two weeks of absence. To compensate employers for the new costs arising, it is proposed that the current employer sickness insurance contribution of 3.3% of all earnings will drop to 1.6%. The proposal should be broadly cost neutral for those employers with an average rate of absence, although they now have a clear incentive to achieve a more productive rate. It is proposed that special assistance be made available for smaller companies with a workforce of less than 250. We're not holding our breath on this one.

Czech Lifestyles and Standards of Living

Czech Satisfaction

Anybody that lives in the Czech Republic will likely have a comment on the Czechs' ever pessimistic attitude towards life. In reality, however, Czechs are satisfied with their living standard. In fact, Czechs are more satisfied with their standard of living than most EU residents, though in the autumn 2004 their satisfaction was still below the EU average, according to the latest national Eurobarometer survey released in September 2005.

Some 83% of Czech said in the spring that they were satisfied with their situation in life, while the EU average was 81%. About 80% said they considered the quality of their life good. The EU average of those giving their quality of life a positive rating is 77%.

A majority of Czechs also said they were satisfied with their financial situation (62%) and the environment in the country (59%). However, only 35% consider the Czech social security situation good, while 47% of Europeans regarded it as positive. Nearly a half of the population (48%) named unemployment as the biggest problem which is more or less the same as the EU average.

Czechs appreciate their education system, with 52% of them considering it better than the European one. On the other hand, Czechs view the European economy more positively than their own, the respective figures being 62 and 36%. On the average, the EU economy is considered positive by exactly half of the Europeans.

Over one-third of Czechs (38%) said their individual situation seems better than five years ago. Last autumn, only 27% felt that their situation improved.

As for their expectations, Czechs are slightly more pessimistic than other Europeans. One-third (32%) believed their life conditions would improve, 55% expected no

change and 12% expected a change for the worse. In the autumn 2004 survey, 20% of them said they expected that their life conditions would worsen this year.

Depending on the type of survey and the type of exact wording used, when people are asked about their own feelings, between 60 and 70% of Czechs say they believe they are poor. We think this reflects to a certain extent the fact that they are not comparing themselves against the average income within the society. Instead, they look abroad to Germany for example, and they see that their disposable income is not any near to what an average person in Germany would have. In reality, neither is the cost of their favourite beer drinking pastimes.

In general, citizens of the new EU countries expect an improvement of their situation, which is more than those from the old EU countries. Fear of unknown effects of EU accession and higher taxes has vanished. In contrast, with the approaching general elections, talks about tax cuts and higher standard of living will become more frequent. The facts are that inflation remains low, real wages are growing and the situation on the labour market is improving as well.

Czech household debt

Year-on-year in May 2005, Czech household debt was CZK 84.5 billion lower than In May of last year. Household debts have been growing for months by a third in the year-on-year comparison, and in May the growth did not slow. The growth in loans has continued this year, with households owing a total of CZK 370 billion to banks as of the end of Q3-2005 and are projected to reach CZK 380 billion at the end of 2005. Of the sum, roughly CZK 40 billion are loans to the self-employed, CZK 250 billion loans for housing and some CZK 80 billion for consumer loans.

There are almost 4 million households in the country, with an average debt of CZK 86,000 per household. Although household debts are growing fast, the situation poses no threat to the economy and most households because most of them are mortgages which are the least risky of loans for banks as well as households.

Rising debts of households and businesses are due to record-low rates which stand behind an almost stagnant volume of time deposits at banks. The volume of loans is higher than that of time deposits. Interest rates on bank deposits and loans are of course derived from the central bank's rates. Thanks to the low rates, companies can take cheaper loans for investments and operation and households find it easier to buy their own homes. The state also benefits from taxation on the enhanced economic activity.

Only some 8% of Czech households have problems repaying their loans. As for loans for housing purposes, mortgage loans and home-building savings, the figure is less than 4%, while for consumer loans it is 13-14%. However, compared with western European states, the rate of indebtedness in the Czech Republic is relatively low.

European Central Bank (ECB) data showed that in 2004 the amount of unpaid consumer loans per capita was some 7.5 times lower in the Czech Republic than the euro-zone average and 20 times lower than in Britain.

Unpaid loans per capita last year amounted to EUR 220 (roughly CZK 6,500) in the Czech Republic, EUR 91 (CZK 2,700) in Slovakia, EUR 252 (CZK 7,500) in Hungary and EUR 313 (CZK 9,300) in Poland. The average for the Euro-zone countries was EUR 1,653 (CZK 49,000) and for Britain EUR 4,303 (CZK 128,000).

PIP refrains from further comment about British habits of attempting to over leverage their investments here in the Czech Republic. The numbers speak for themselves.

One of the biggest risks in the Czech Republic is that for now consumers do not have sufficient experience with loans. The debts of Czech households are still very low compared with Britain because the Czech consumer loan market is quite young.

However, we expect the number and volume of loans in the Czech Republic to grow in the future, as will the risks that the households will be unable to pay them back. In 2004, a growth in mortgage loans (+52.8%) and loans from building societies (+32.4%) was much higher than the growth in consumer loans (+13.7%). Furthermore, the untapped market for mortgage loans still stands at roughly 90% leaving incredible room for sustained growth well into the future, which will only affect capital values on residential properties in a positive manner.

Incidentally, The European Central Bank (ECB) reported in October 2005 that over 98% of the volume of consumer loans in the EU were taken in the fifteen "old" EU members.

Household deposits increased. One-day deposits were CZK 7 billion higher, but deposits with agreed maturity went down by CZK 3.3 billion and deposits redeemable at notice decreased by CZK 732 million. The growth in household deposits is a healthy phenomenon but growth in long-term deposits would be better for creating new resources to finance GDP growth. This, however, is prevented by low interest on deposits. People with money deposited in a bank account get lower interest than inflation and are losing money in real terms. Hence, the low savings levels.

Businesses owed almost CZK 606.3 billion at end of May, a rise of almost CZK 6 billion compared with April. One-day deposits posted a rise of CZK 32.3 billion to CZK 315.3 billion, and deposits with agreed maturity were CZK 8.6 billion lower at CZK 234.7 billion.

The rising debts of businesses should not be alarming either. GDP growth is at 4.4% this year, and with interest rates at record lows it is quite logical that companies are drawing loans for investments. The wave of investments in not over and strong GDP growth should also be seen in the next few years.

Credit Cards

One in ten Czechs will have a credit card in four years (i.e. by 2009), according to estimates by HVB Bank. At end of March this year, Czech banks registered 410,548 credit cards. The number of credit cards in the Czech Republic had almost doubled in 2004 and should grow to 1.165 million by 2009, according to HVB.

Czech clients use almost six million debit cards, but experts have said this market was satiated and offered no room for growth.

Lifestyle Trends

Czechs are motivated to learn foreign languages

A 2005 study by Eurobarometer, the European Union's polling agency, reported that Czechs master foreign languages above the EU average.

Sixty-one percent of Czechs polled said they speak at least one foreign language, compared to the EU average of 56 percent. Thirty-three percent of Czechs said they

speak two foreign languages, while the EU average is 28 percent. German, spoken by almost 30 percent of Czechs, is the most common foreign language here, followed by English (24 percent) and Russian (20 percent).

The report measures the progress of a long-term EU objective that all citizens speak two languages in addition to their mother tongues. Almost 30,000 citizens among the 25 EU states — including 1,029 Czechs — took part in the study. According to the study, only people from Luxembourg and Latvia are more motivated than Czechs to learn foreign languages.

There has been amazing language progress in all generations, mostly because people are aware of how important languages are for their job proficiency. Most Czechs say they learn foreign languages in order to improve their job opportunities. But more young Czechs than ever before are travelling abroad, which also factors in.

At least among younger Czechs, English is seen as the most useful foreign language. Czechs start learning it in fourth grade. Education Minister Petra Buzková wants to spend 5 billion Kč (\$211.5 million) to begin teaching it in first grade. In the plan, students would begin a second foreign language in eighth grade.

A lack of qualified teachers is remains an obstacle.

More and more Czechs are realising that the Czech Republic is a small place, and people aren't very likely to learn their language. So, they themselves must adjust to the big European family.

Czechs increasingly interested in exotic destinations

Czechs usually spend their holidays in Europe, but with the rising standard of living, the number of people seeking exotic destinations is also rising. The basic trend has not changed much, with standard holiday destinations being Bulgaria, Croatia, Egypt, Greece, Italy, Spain and Tunisia. But, as the purchasing power of Czech citizens grows, so does the demand for more remote and exotic destinations, such as Asia, Africa and America.

According to CzechTourism data, 939,000 Czechs spent four or more nights in Croatia last year, 437,000 in Italy, 196,000 in Spain and 187,000 in Greece. An ever larger number of tourists is interested in visiting St.Petersburg, Moscow and cities in other countries of the former Soviet bloc, such as Estonia, Latvia, Lithuania and western Ukraine.

About 55,000 Czech tourists visited the American continent last year, 81,000 visited Asia and 274,000 spent their holidays in Africa, with 146,000 and 97,000 visiting Tunisia and Egypt respectively. Egypt, Tunisia and Turkey are destinations with the most last minute trips and the cheapest offers.

New successful destinations are Australia, Botswana, Jordan, Malaysia, Malta, New Zealand and Oman. Czechs have also started to take trips to the Dominican Republic, South America, South Africa and the Caribbean Islands. In Asia, Thailand is becoming a traditional destination, despite its visa regime. About 14,000-16,000 Czechs will visit Thailand, the Maldives, and Sri Lanka between autumn 2005 and spring 2006, which will be 20 to 30% less than before the tsunami. Demand for travel to China has increased by more than 50% year-on-year. However, countries like Burma, Cambodia, Laos and Vietnam are still unknown destinations for Czech tourists, while tourists from the West have already begun to travel there.

Two-thirds of middle-aged Czechs enjoy sex

More than 70% of Czechs between the ages of 40 and 65 say they are completely satisfied with their sex lives, have sex regularly and decided about sex quickly, a poll taken by the STEM/MARK agency released in June 2005 shows.

STEM/MARK said that the goal of the poll was to understand the sexual practices of the middle-aged population of the Czech Republic. What is surprising about the results is how often people have sex with their long-term partner. Two-thirds of those polled said that they have sex twice or three times a week.

The importance of sex in a partnership drops with age, but never disappears. For both genders in middle age, the most important thing is spiritual comfort and harmony in the relationship. Men place more importance on the quality of their erection, while women prefer their surroundings, the length of foreplay and non-sexual factors.

A total of 17% of women and 18% of men said that they were very satisfied with their sex lives, while 53% of men and 54% of women said that they were on the whole satisfied. Another 21% of men and 22% of women said that they are not very satisfied and 8% of men and 7% of women said that they are not satisfied.

Men have a greater need for sex, with 53% saying they have a great need, while only 39% of women said the same thing. Half of the women polled said that a man should initiate sex. The poll also showed that people decided on sex quickly and not even 30 minutes goes by between their first thoughts about sex and the act itself. About half of those polled said it takes them ten minutes.

Some 53% of men between the age of 60 and 65 said that they suffer from erectile dysfunction.

Czechs postpone marriage and childbirth

Czech men and women continue to postpone marriage and parenting and more women than ever before, nearly 40 percent, are childless. The Czech Republic had 10.2 million inhabitants at the end of 2004, 51.3 percent of them were women.

The probability that a woman remains without children has doubled since 1993. Women married for the first time approximately at the age of 23 on average in 1993, while the average age for a first wedding last year was 28 for women and 30 for men.

Women gave birth to their first child at the age of 26 years on average in 2004, while in 1993 women having their first child were 4 years younger.

Experts say this trend is caused by a change in people' values. Couples prefer a professional career and travelling to family life. The number of women who graduate from university increased over the past two decades and the number of university graduates in the 25-39 age group is almost the same for men and women. The availability of contraceptives and possibility of family planning play a role as well, and the above trend is expected to continue.

People also get divorced at an older age. The average age of divorced couples has increased by 4 years since 1993, being about 37 and 40 for women and men, respectively. Likewise, an average marriage lasted 12.1 years in 2004, while it was 10.5 years in 1993.

Czech Republic experiences small baby boom

Czech women who were part of the country's baby-boom in 1970s are finally having their own children. Experts hope that the birth rate over the next five years will be even higher than their most optimistic expectations.

The atmosphere in society has been gradually changing so that it is now almost a trend to have a baby. The decrease in the Czech birth rate stopped in 2003 when 93,700 babies were born, at least 2,000 more than in 2002. In 2004, 97,700 babies were born in the country.

Still, the Czech Republic, along with Slovenia, still ranks among the EU countries with the lowest birth rate of 1.23 children per woman. Hungary, Poland and Slovakia also have a very low number of newborn children. The EU average is 1.5 children per woman. In the EU, The highest birth rate is in France, Finland and Ireland, but even in these countries the average is under 2 children per woman, which is the rate needed to prevent a population from declining.

It has recently been hard to find expectant mothers around 20, as Czech women prefer to have their babies later in life. They had a lot to do until then: they studied, built their careers or travelled. Still, families currently want only one or two children.

More children born out of wedlock

In the first quarter 2005, the share of children born out of wedlock exceeding 31%, according to the Czech Statistical Office data. The number of children born to single mothers has been growing in the Czech Republic since the end of the 1980s.

The number of children born to single mothers has grown more than twice since the beginning of the 1990s, when only 10% of children were born to single mothers in 1990. Previously, there existed a myth that more and more children are born to parents who are not officially married. But the recent research showed that this is no longer true.

According to a study from Charles University, 57% of mothers with a low level of education did not have a husband in 2003. They were mainly single mothers whose partners do not help with the upbringing of their children much. On the other hand, single mothers with university education make up only 8%. Unlike western countries, Czech university-educated women behave in a more conservative manner and only give birth to children after marriage. Nevertheless, more and more women in this category do not plan a child.

The situation in the Czech Republic differs from the situation in other European countries, though one-third is the EU average for children born out of wedlock. In the more predominantly Catholic Slovakia the figure is one fourth of all newborn babies. The largest number of children born out of wedlock is in Scandinavia. The number of single mothers in Iceland is 63% and it is more than 50% in Sweden, Norway and Estonia. In Britain, Denmark, Finland, France, Lithuania and Slovenia, the figure is over 40%. On the other hand, the smallest number of children born out of wedlock is registered in countries of south Europe. For instance, only 4.6% of Greek mothers do not have husbands.

Alcohol Consumption

Besides taking claim towards the worlds' highest beer consumption per capita, on average Czech children allegedly taste alcohol for the first time at the age 11, which is

the lowest age the EU according to a study by the European Forum for Responsible Drinking.

According to the statistics, the share of underage children who regularly drink alcohol and get drunk is relatively high in the Czech Republic. Nevertheless, the most serious problems with children's alcohol consumption are in Britain, Denmark and the Netherlands.

13 percent of Czechs aged 15-16 get drunk at least three times a month, and the same share of children drink alcohol at least ten times a month. Over a half of the children surveyed said that they had already been drunk twice in their lives.

Statistics also show that children in Central and Eastern Europe are increasingly drinking alcohol with the aim of getting drunk. In the Czech Republic, 18 percent of 15-year-old children and in Slovakia 15 percent admitted getting drunk, while up to one-third of all children have this habit in Britain, Ireland, the Netherlands and Sweden. Children in Austria, Belgium and the Netherlands drink the most regularly. One-fifth of 15-year-olds drink alcohol at least ten times a month in these countries. Boys drink alcohol more frequently than girls in the EU. However, in some Scandinavian countries girls are more frequently reported drunk than boys, or the figures are almost equal for both groups.

On the contrary, alcohol consumption is not so popular among children and young adults in France, Portugal and Italy, though the total alcohol consumption in these countries is one of the highest in Europe.

In most of the EU countries, including the Czech Republic, alcohol consumption is legal from the age of 18, but in Norway it is allowed only from age 20.

Unlike in the Czech Republic, in a number of European countries beer and wine are distinguished from hard liquor and can be consumed from the age of 16.

Real Estate Markets

Key trends in the Czech real estate market

In contrast to 2004, the 2005 outlook for developers has improved, particularly for mixed-use developments (modern high-quality office, retail, and residential space). In terms of property types, shopping centres are again expected to produce the highest total returns in 2005, while retail parks outrank residential as the second most favoured investment choice. The residential sector is listed as top choice for development, followed by shopping centres and warehousing/distribution space.

- ***Office:*** Central business district office prospects for 2005 rank as “fair,” while prospects for business parks and out-of-town properties are viewed as “modestly poor.”
- ***Retail:*** The retail sector, through shopping centres and retail parks, is considered to have the best performance prospects of any real estate sector. However, overall retail performance will slow in 2005.
- ***Industrial:*** The industrial market is positioned for substantial growth in 2005.
- ***Hotels:*** Buoyant demand for hotel assets should boost sales and help forecasts of record highs for European hotel transactions become reality.

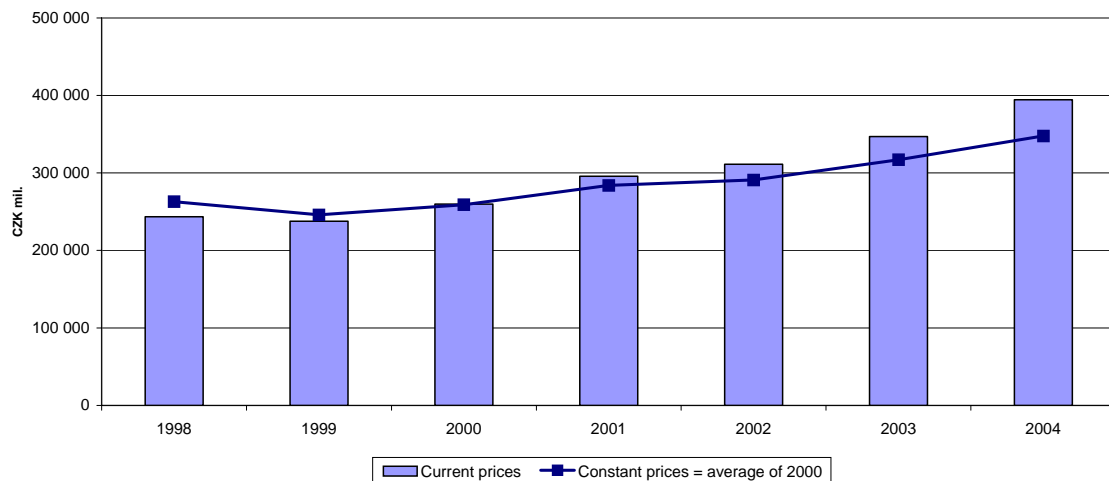
- **Residential:** Demographic changes – rising numbers of households and an aging population – will affect the housing market. Local market knowledge will be the key to identifying opportunities at the right moment in the local/regional/national cycle.

Construction output

Year-on-year construction output rose by 6.7% in constant prices in August 2005, up from 6.1% in July, according the Czech Statistical Office [CSU]. After accounting for the additional working day in August 2005 over August 2004, the rise was 5.4%.

The growth of construction output grew particularly in the area of new construction in civil engineering. The volume of construction work on repair and maintenance of constructions decreased. The results for August 2005 proved that the period in which the reconstruction output data was affected by the increase in the VAT rate last year for non-housing construction has come to an end.

Development of construction output in the years 1998-2004



Month-on-month, construction output was 2.1% higher in real terms adjusted for seasonal effects.

The planning and building control authorities granted 14,397 building permits in August 2005, of which 7,704 for new construction and 6,693 for renewals and enhancements. The approximate value of the construction permits issued in the same period reached CZK 36.9 billion, of which new constructions accounted for CZK 20.2 billion and renewals and enhancements for CZK 16.7 billion. The high approximate value of renewals and enhancements was affected by the permit granted for further large reconstruction of the railway infrastructure.

Retail

Overview

The Czech Republic has one of the most developed retail markets in Central and Eastern Europe. Domestic retailers are better off as people are beginning to spend more money and sales are growing faster than before. In particular, retail sales interest in luxury goods up. In fact Czechs are spending more on luxury goods and doing more shopping on the Internet. Compared with the EU, sales in Czech retail outlets are growing two times faster. From the whole EU, the highest growth in sales was in Lithuania (nearly 14%), while in Luxembourg there was a 2% fall.

This year retail sales grew by 3% year-on-year in June 2005 and by 4.4% when including the automotive segment. Sales in Czech retail outlets have been rising constantly since the 2002's disastrous floods, with the exception of January 2004. Consumption should thus become one of the driving forces of the economic growth.

Sales are growing in particular in the automotive segment. Czechs are investing more and more money into their beloved cars; however, they are unwilling to spend as much money as before on fuel, so sales at petrol stations are growing slower than before. Mail-order sales are growing as well, mainly thanks to a growth in e-commerce. This sales method should become more popular as the number of households with Internet access on the rise.

For clothing and footwear, Czechs paid nearly 10% more than a year ago. Prices of clothing have been falling in the long term, but with the growing standard of living, people are willing to pay more for fashion than before. Hence, Czechs are demonstrating their demand for quality. Also, more brand name shops are appearing in the Czech Republic. Sales of luxury goods are growing constantly in the Czech Republic. This shows that society on average has gotten over a breaking point from which it considers itself richer and people are buying goods just for pleasure.

The times of cheap clothing bought at market stands are ending gradually. But, don't count this sector out just yet. Czechs still spend billions at Asian market stands. In fact, Asian shops and market stalls are the main or second main place where 20% of Czechs buy clothing, and stall owners earn CZK 10 billion in annual sales from clothing and textiles alone. Cheap clothing in market stalls and shops is sold almost exclusively by Vietnamese immigrants, and is produced by the Chinese. The number of Vietnamese shops with vegetables and food is also rising.

Still, the role of market places is getting moderately smaller. Sales outlets are being moved indoors. The same Vietnamese entrepreneurs agree that Czechs are laying more stress on comfort in shopping. They say that Czechs have more money and are becoming more demanding.

Hypermarkets and Supermarkets

Today, there are 160 hypermarkets in the Czech Republic, alongside more than 200 smaller supermarkets and over 300 discount stores.

With a population of 100,000, Hradec Kralove has 1,490 square meters of sales area per 1,000 inhabitants, a ratio among the highest in the country. The increase in competition, as well as a consumer shift from supermarkets to hypermarkets and discount chains is forcing many supermarkets to reconsider their locations, but not necessarily leave.

Key Supermarket Players

The 10 largest Czech retail chains' aggregate turnover totalled CZK 221.5 billion in 2004, some CZK 20.1 billion more than in 2003. Since 2001, sales at the top 10 retail companies have been growing more slowly than in the preceding years, but the sector is far from stagnant. The main source for retail-market growth has been the expansion of smaller hypermarkets and discount chains.

A recent study conducted by PricewaterhouseCoopers indicated that major retail chains were ready to expand in this country despite the strengthening competition.

German chain Lidl, which entered the Czech market in 2003 and opened around 100 discount outlet store here by the end of 2004, is likely to be among the fastest expanding players on the domestic market this year as well. Although Lidl's management does not wish to disclose the company's expansion plans, market analysts speculate Lidl plans to operate around 200 shops across the country.

Ahold Czech Republic, which runs Albert supermarkets, the largest Czech chain, will open four new Hypernova hypermarkets and seven Albert shops here this year, the same number as last year. At the close of 2004, Ahold had 184 Alberts and 47 Hypernova outlets in the country.

The Belgian chain Delvita wants to build five new outlets in the Czech Republic this year atop of its existing 96 stores.

The Dutch chain Makro Cash & Carry, which currently runs 11 wholesale centers in the Czech Republic, plans to open one more outlet in 2005. Meanwhile, the British Tesco will open at least five new outlets this year. French-based Carrefour, which has 10 hypermarkets in this country, will open a new shopping center in Prague this year and Germany-based Globus intends, to open one new shop.

High Street Areas

Flooded by big and small shops and shopping arcades, Vaclavske namesti and three streets around the edge of Stare Mesto – Na Prikope, 28. rijna and Narodni trida (with a TESCO store) – are considered to be the Prague's shopping centre. They offer everything that can be sold – from label clothes and perfumes to traditional wooden toys and vegetables, so you should be able to buy all you need. Of course there are plenty of excellent (often very specialized) shops scattered throughout the City, e.g. very prominent (and expensive) shops are located on Pařížka ulice (near Staromestske

TOP CZECH RETAIL CHAINS

Listed by 2004 turnover, in billions of CZK

Rank	company/group	Sales '03	Sales '04
1.	Makro Cash & Carry CR	35.7	38.2•
2.	Ahold Czech Republic (Hypernova, Albert)	32.5•	34.6•
3.	Schwarz CR (Kaufland, Lidl)	27.0•	34.5•
4.	REWE CR (Penny Market, Billa)	22.3•	23.3•
5.	Tesco Stores	19.0•	21.0•
6.	Globus CR	18.2	19.0
7.	Tengelmann CR (Plus, OBI)	17.7•	18.9•
8.	Carrefour CR	10.0•	11.0•
9.	Spar CR	9.0•	11.0•
10.	Delvita	10.0•	10.0•

•Estimated figures

Source: Incoma Research

namesti / Old Town Square). There is an average of 250,000-1 million square meters of retail shopping on other high streets in the world, but the area of Na Příkope, Wenceslas Square and down to Kotva is less than 100,000 square meters. Prague is only at about 40% of its retail capacity.

Nevertheless, the concept of high street retailing in Prague is entering a new, even more exciting phase. The root cause of it is hard to pinpoint, but there a number of factors that are combining to bring about this revolution. The location, of course, is ideal, as it's sandwiched in between a pair of busy metro stations and is within easy walking access of major tram lines that branch out across the city. It's also well-positioned to take advantage of both Prague's booming tourist industry and a well-developed business district. Prague's Central Business District [CBD] is perhaps a nebulous notion whose precise location shifts depending on which developer is talking. But despite the fact that there's virtually no room for new build offices in the centre, enough business centres and quality reconstruction projects have been built to guarantee that an extremely attractive customer base is always nearby.

At the moment, Prague's high street basically dissolves without warning. Suddenly, you're standing in front of the massive National Bank building, looking at a huge, run-down building wondering where all the shops went.

Shopping patterns for people living in Prague make a weekend stroll downtown more of an exception than a rule, while trips out to the various shopping centers around town are far more common. This is obvious when looking at the daily revenue figures of the malls. But it's these weekend numbers that are likely to start changing.

The lack of availability coupled with strong demand for prime locations have been the main factors behind the growth in rents. The supply of new retail stores in the city centre will remain small for the next two years.

The most notable recent developments have been the opening of Western-style shopping centres such as in Letnany. Near to the centre are situated shopping centres Smichov (stop Anděl -- line B or tram 9) and Palac Flora (stop Flora line A or trams 5 and 16). "Bontonland" on Vaclavske namesti offers the biggest collection of music CDs. The big shopping centres are situated in Prague's outskirts – the biggest are Zlicin (with IKEA and HyperTESCO) and Cerny Most (both the end station of Metro line B). Each centre consists of approximately 100 retail tenants, attracting a broad range of new and innovative retailers to the Czech market. These include Mango, Ecco, Sephora, Next, Promod and Mexx. H&M is slated to arrive this year. Europark Sterboholý, Prague 10, opened in September 2002. This centre includes the Interspar hypermarket and the first Hervis Sport unit in the Czech Republic.

Today, there are 160 hypermarkets in the Czech Republic, alongside more than 200 smaller supermarkets and over 300 discount stores.

Na Příkope

Of all the high streets in Central Europe, the one that stands out head and shoulders above the rest is Prague's Na Příkope. From rather modest beginnings, when retailers were having enormous difficulties trying to secure locations along it, Na Příkope has blossomed into a bustling street full of services and high-end fashion. Mango's purchase of an entire building, the upper floors of which it turned into classy office space, was perhaps the real sign that things were changing. Another important milestone was Zara's store in the Detský dům across the way, breathing life into what

had seemed a terminally troubled project. And then there was Promod's flagship store at the base of Wenceslas Square which really sealed the deal.

Na Příkope's true arrival seems to have been confirmed by a pair of recent studies by Cushman & Wakefield Healey & Baker. The first is that at Euro 1800 per square meter per year (EUR 150/m²/month), Prague has defended its position as the 18th most expensive retail location in the world, ahead of Amsterdam and Copenhagen, and just behind cities like Oslo and Vienna. Rents a year ago on the street were Euro 120 lower, so the popularity of the location is certainly not waning. By comparison, Budapest managed just 29th place, while Warsaw took 38th.

Wenceslas Square

It's only a matter of time before Wenceslas square itself becomes a permanent component of Prague's high street. A study by C&W H&B showed that more than 45,000 people walk by the lower part of Wenceslas square and that roughly 57,000 pass along its middle section. (A successful shopping mall in the Czech Republic will get 100,000 people per week, and for further perspective, the Champs-Elysees has around 100,000 pedestrian per day.) The right-hand side of the square (if you're facing the top) enjoys a 25% advantage over the left-hand side. Between 25,000 and 30,000 people go by the Bata store and Wenceslas 30 at the base of the square, while 20,000 to 25,000 see Wenceslas 17 up close. Rush hour for walkers occurs at about 3 pm on working days. On weekends, the push, such as it is, waits until between 4-5 pm. Weekend numbers are substantially lower.

Marks & Spencer, which just opened an attractive new store on the upper section of Wenceslas square hasn't even seen a dip on its revenues in its existing store in Myslbek on Na Příkope.

Residential

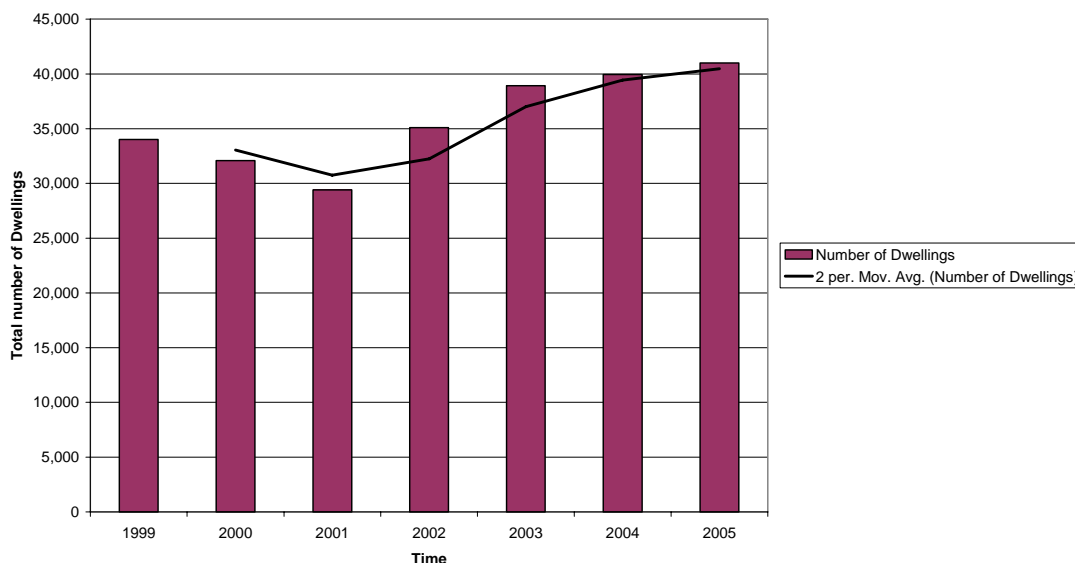
Supply

The number of flats completed in the Czech Republic in 2004 was the highest since 1992. The Czech housing under construction continued rise last year, with the number of completed flats up at 32,268, the highest since 1992, and the number of flats whose construction began at 39,037, most since 1990 (*Source: Czech Statistical Office, Mar-05*).

In the long term most homes are built near cities, such as Prague and in Central Bohemia. The lowest number of housing-starts was in the Karlovy Vary region in West Bohemia and in the Hradec Kralove region of East Bohemia. Most flats were completed in Prague and Central Bohemia, and the lowest number in Karlovy Vary region and Usti nad Labem region in North Bohemia.

The number of housing-starts was 7% higher year-on-year, mostly in multi-family apartment buildings, non-residential buildings, converted non-residential premises and family houses. The number of homes under construction was also higher in a year-on-year comparison, up by 7,669 at the end of the fourth quarter. Home extensions started were on the decline.

**Number of Dwellings Permitted for Construction
1999-2005**



The number of completed flats grew by 19% vs. 2003, with the highest growths seen in multi-family apartment buildings, family houses and extensions. In Q4-2004 alone the number of completed homes was a fifth higher at 12,336. A fall was seen primarily in non-residential buildings and community care service homes.

Modernised homes numbered almost 15,500 last year, up by a fifth over 2003. There is also a need to invest an additional CZK 300 billion into existing housing due to the use of cheap materials in the past.

Authorities in August 2005 also permitted 4,166 dwellings to be constructed, an increase of 533 dwellings year-on-year. The number of new dwellings to be obtained following renewals and enhancements should reach 705, a decrease of 186. The approximate value of the newly permitted dwellings in multi-dwelling buildings reached CZK 8.3 billion.

The average approximate value of a dwelling in a new residential building stood at CZK 2.3 million, which translates into CZK 18,200 per m² of floor space, the average size of dwelling being 128 m². The average approximate value of a dwelling obtained by renewal or enhancement of an existing residential building was CZK 1.2 million, with the average size of the dwelling 82 m², CZK 14,500 per m² of floor space.

Demand

The positive result was owing to growth in contracts for mortgage loans and home-building savings and thanks to the interest rates. Further contributors were developer projects for the construction of housing complexes.

Access to Financing

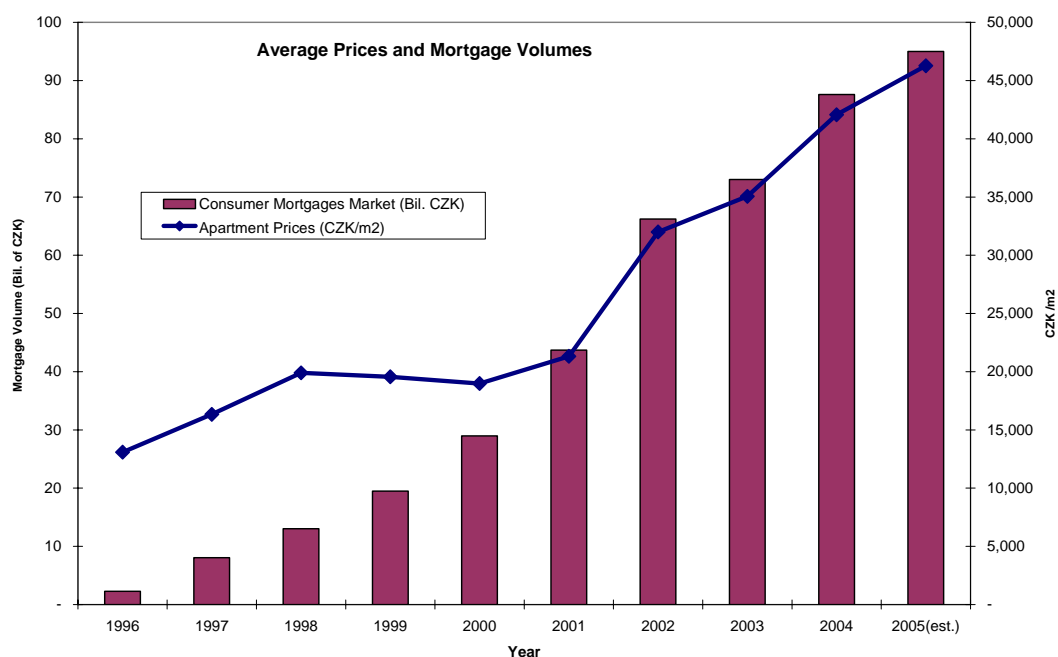
Despite relatively low mortgage rates and government support of new-housing loans mortgage accessibility is still far from what it is in more developed markets. Many mortgage applicants are still in a subordinate role to the banks.

The government approved low-interest loans Dec. 2004 for people under the age of 36 who want to buy their own home, but we warn that simply throwing money around

will be of little help unless the existing housing system and financing of home purchases changes. The maximum level of the newly approved loans, which can only be used for housing purchases and not for reconstruction, is CZK 300,000 (EUR 9,715) with an interest rate of 2% and a maturity of 20 years. Only married and singles with children are eligible for the loans. The State Fund for Housing Development will start paying out the loans in the middle of December 2004 and the money would maybe cover 1,000 clients in 2005.

The most important factors for choosing a home remain price and the ability to qualify for mortgages. Location, neighbourhood, and proximity to work, school, family and friends comes next.

Developers are taking the demographic seriously and targeting first-time buyers who will finance new housing through mortgages. Hence, relaxed payment schedules have become the tool for granting concessions.



Source: CSU & Property In Prague, 2005

Government loans, better access to mortgages, and increasing demand from young people will continue to fuel a residential construction boom.

The Luxury Sector

In recent years, foreign businesspeople and wealthy Czechs have come to demand standards similar to those in Western Europe. Prague's finest apartments - and their prices - are gradually catching up to those in Western capitals. High-end clients, for example, don't like buildings with 100 other apartments. They also don't like ground-floor apartments.

Prague's high-end real estate market has been hot since foreigners poured into the city in the mid-1990s and gobbled up the relatively few luxury apartments available. It gained steam beginning in 2003 and really heated up last year as the country's entry to the European Union brought a fresh influx of foreign businesses and managers.

Prices for Prague's nicest apartments and homes have risen since 2000 from a ceiling of around 100,000 CZK/m² meter to 250,000 CZK/m². A nice two-bedroom

apartment is typically around 100 m², or 1,075 sq.ft. Despite skyrocketing prices, supply isn't keeping up with the number of interested buyers. In our experience we never have enough good apartments in the historic parts of town, and when we find them, they sell immediately.

The most popular addresses in the "Golden City," as some call Prague, are apartments in refurbished buildings in areas like Mala Strana, a cobblestone row of Baroque palaces and churches that runs along the Vltava, the river that cuts the city in half.

From here, the old town, a maze of Gothic, Baroque and 19th-century architecture, is a short walk over the 14th-century Charles Bridge. Many buyers want to live in the centre of this distinctive architecture, but they also want to live in renovated buildings with amenities such as hidden garbage bins and a steady supply of hot water. For them, only a dozen or so apartments may be available at any given time.

Many of our private individual clients, want to buy an apartment in the historic part of town but find it difficult to find anything that met their standards at the price they want to pay. A lot of buildings look nice on the outside. Then you see the interior. The kitchens are like something out of the 1970s. Linoleum floors instead of wood. Few places in the historic areas have balconies.

Part of the shortage of good apartments in Prague's historical section is due to the city's rent regulations. On a recent weekday, a developer showed an apartment priced at more than EUR 1 million. Across the way, an old man smoking a pipe sat on a windowsill of a building that looked much like the one the developer had renovated - except the walls clearly not been painted in years and the interiors looked dated. In essence he's paying about EUR 100 a month for that place. On the free market, in this area, the landlord could get EUR 1,800.

Owners are reluctant to invest in buildings with regulated rents, and agents advise clients not to move into them. That leaves developers focusing on new construction or renovation of special properties.

One of the most expensive properties now on the market is a four-room apartment in a four-story Baroque building that was a hotel when Beethoven stayed there for a month in 1796. Developers are asking CZK 70 million for the place, which comes with four 18th-century wood-burning ceramic stoves. Before one complains about the seemingly absurd price, the property is indeed unique, even within its own historic area.

Nonetheless, prices like that one have some observers fearing a bubble, however, we still see none in sight. We point to three factors likely to keep the market hot: Czech real wages continue to grow, with a 3.9% increase in the first half of the year alone; mortgages are on the rise; and foreigners are still arriving, including managers from Vodafone and Telefonica, telecom giants that bought Czech companies this year. Market conditions are still developing, which means prices will continue to rise.

While Prague's real estate market is no longer the bargain it once was, foreigners still consider it to be good value for their money. One would have paid 2.5 times more for a comparable apartment in London. 100,000 CZK/m² will buy a luxury place in Prague - and a run-of-the-mill apartment in Spain.

We also note that the yields are much higher here. In Prague, you get a 5% to 8% yield plus 5% to 15% capital growth. Right now in Spain, or Ireland, you only get capital gain.

With quality apartments in historic buildings in short supply, more and more developers are constructing high-end apartment buildings. River Diamond, to be finished next year, is an apartment complex along the Vltava that offers amenities like Jacuzzis on the terraces. Another development, Central Park Praha, aims to provide tenants with Manhattan-style service, including doormen and a fitness club. It is scheduled to open next summer. In the past, Czech developers were schizophrenic; They claimed quality, but were afraid to deliver. That's starting to change.

A planned tax increase is likely to keep the market brisk in the near future. In 2008, value added tax on real estate purchases is set to jump to 19%; it is now 5%. Our strong suggestion to clients is to buy before that happens.