& CHANGING MINDS ECONOMIC MODELS

PETR TEPLÝ FOR VISEGRAD INSIGHT

What What are the real reasons for the economic stability and growth in the Czech Republic over the last few years?
Since there have been no recent internal imbalances in the Czech Republic, this has lead to a stable economic environment. This positive trend has been influenced by the following conditions. First, the increase in household consumption is being fuelled both by the growth in employment as well as more supportive fiscal measures. Second, exports are increasing due to the solid economic performance of Czech trade partners and by the weak value of the Czech crown. Third, there has been solid growth in the rate of fixed investments mainly due to a higher absorption of EU funds. Fourth, expansionary fiscal policy has contributed positively to economic growth. In 2016 alone, the domestic and external demand was favourable for local industries (mainly for the manufacturing industry). All these factors are supported by sound public finance and a stable banking sector, which is well-capitalized, liquid and profitable.

INNOVATING THEIR WAY TO THE FUTURE, THE CZECH REPUBLIC'S STRONG ECONOMIC

Is the Czech economic dependence on the manufacturing and automotive industries dangerous? Do you see any attempts to find new sources of growth for the future?
Yes, it does pose a risk as having such high dependence on any one industry can be a double-edged sword. On one hand, the Czech economy is well integrated into the international (German) production chain and the auto industry with a share that is approximately 20% of total exports serving as an engine of growth recently. On the other hand, it makes our economy very sensitive to business cycles. Besides this low sectoral diversification, the Czech economy is also facing low geographical diversification since two thirds of exports go to the Eurozone and one third to Germany. Czech exporters are reacting to this situation and are looking for new trade opportunities in "emerging" territories such as Africa or Latin America. At the company level, many firms have set up innovation hubs to find new growth opportunities. For instance, ŠKODA AUTO, a famous Czech car manufacturer, established the ŠKODA Digital Lab last year in order to follow recent developments in the automotive industry (diverse mobility, autonomous driving, electrification and connectivity).

The Czech economy is a small, open and export-oriented market primarily based on skilled, low-cost manufacturing. It is not a sustainable business model and this comparative advantage will not last forever. The economy needs to upgrade in the global value chain: either through higher value added production or moving towards the service sector. Consequently, the Czech government has reacted to this situation and approved the "Industry 4.0" concept in August 2016, which follows the German "Industrie 4.0" concept reflecting the ongoing Fourth Industrial Revolution.

Where would you see such possibilities for future growth? Where might be new areas of development?
The above-mentioned Industry 4.0 concept encompasses the digitalisation of production processes based on devices autonomously communicating with each other along the value chain. The concept will affect two main areas of development: intelligent factories (based on Cyber-Physical Systems) and the service sector (big data technologies, the Internet of Things and Internet of Services etc.). Obviously, this is a long-term plan.

At the same time, several Czech companies are able to withstand fierce global competition and are showing others the possibilities for future growth. AVG, a security software pioneer, and Avast, a company offering antivirus software, are the country's two technology unicorns. Moreover, Jablotron, a company producing security devices and mobile phones, and Linet, a major European manufacturer of hospital and nursing beds, have been expanding into international markets successfully without any significant government support. Last but not least, Delong Instruments and TESCAN are top-ranked global suppliers of electron microscopes.

Is, according to your opinion, the Czech economy too dependent on Germany's?
Yes, one third of Czech exports go to Germany, which is a high percentage and understandable for several reasons (proximity, socio-cultural factors, etc.). The Czech economy, like many others, is small, and therefore cooperates with stronger partners, who have opened the global market for Czech exporters. Let me mention one paradox that happened during the 2007-2009 crisis. Many German exporters reacted by implementing strategies, most notably through cost savings, and demanded more supplies from

"cheap" Czech exporters, which paradoxically helped the Czech trade balance.

The Czech Republic reports a high share of industry (38%) and a low share of services (60%) on Gross Domestic Product (GDP), which makes it more vulnerable to economic shocks compared to the better-diversified German economy. Some readers might be surprised that the Czech economy is more similar to the Polish economy rather than the German one (based on the Landesmann index measuring structural similarity of economies). This also implies a higher risk of asymmetric shocks resulting from the single monetary policy in the Eurozone. This relatively low structural similarity of the Czech economy compared to the Eurozone consequently brings another potential risk with regards to adopting the Euro.

Currently, what is the biggest danger for the Czech economy?

The current key risks are external since I don't see any significant internal imbalances of the Czech economy yet. A global slowdown or changing growth patterns in key export partners would negatively affect Czech exports through value chains, however. As a result, GDP growth could deteriorate.

PERFORMANCE MAY NOT BE A DECADE-LONG BUBBLE BUT A SIGN OF THINGS TO COME

Apart of these external risks, one theoretical internal risk might materialize. In 2017, the Czech National Bank´s foreign exchange intervention – which was launched in November 2013 to meet the 2% inflation target – is expected to end. If the withdrawal of the stimulus is sudden and not fully absorbed by the markets, the Czech crown might become very volatile for a short period of time and cause uncertainty. Moreover, a significant appreciation of the crown against the Euro would hurt exports and hence the GDP growth of the Czech Republic.

How long can the Czech Republic and other Central European countries rely on lower wages as the main attraction for direct foreign investment?

It's difficult to say, but let me take a stab at it. As discussed earlier, the recent model of Central European countries – which has been based on skilled, low-cost manufacturing – is not sustainable. In comparison, the current wages in the Czech Republic are approximately one-fourth those in Germany while Czech labour productivity is about half of their western neighbour. This gap should close in time (in economics we call it beta-convergence). Mathematically, if we assume that wages in Czech Republic grow by 2% faster than in Germany, such a gap will close in 35 years (a 5% increase would close the gap in 15 years). These calculations –although simplified since assuming constant productivity growth in both countries- illustrate a long-term horizon of closing the gap.

There is growing criticism in Central Europe of foreign companies which take, according to some opinions, too much money out of daughter companies and countries in the region. Finance is then missing when considering future local investment and can also contribute to lower wage levels. Are countries like the Czech Republic giving too much too easily to foreign investors in this sense?

Foreign investors invest abroad in order to make money. If they see profit potential in a company, these investors reinvest the profit. If they do not, they ask for the invested money back (usually through dividends). Let us have a look at the case of the Czech Republic, where capital outflows are estimated at EUR 11 billion (6% of GDP) annually. There are three main reasons. First, the Czech Republic used to serve as "The Gateway to The East" for investors from Western Europe, which is not the case anymore. On the other hand, the Czech Republic has served Chinese investors as "The Gateway to The West" in recent years. Second, some investors suffer from labour market shortages and skill mismatches, which pose risk for medium-term growth prospects. Finally, some investors can achieve higher profits in other countries than in Czech Republic.

It is also a political issue. Politicians may impose or increase various taxes that make capital outflows less favourable (e.g. sectoral tax or higher tax on dividends). To illustrate this let me mention that the Social Democrats, a Czech political party, proposed a sectoral tax on banks this February. A dividend outflow worth EUR 17 billion in last 14 years from banks in the Czech Republic to their parent companies in Western Europe was listed as one of the reasons.

Can innovation help Central European economies leapfrog from being cheap sources of labour to mature economies on par with other, more established countries in the EU?

Yes, innovations might help to change the pending low-cost business model of Central European economies. In terms of innovation, most Central European countries are rated by the European Commission as Moderate Innovators implying their level is below the EU average innovation performance. However, many Central European scientists are neither properly motivated for closer cooperation with businesses through applied research nor for developing innovations. The system of research and development (R&D) financed in many countries needs to be updated. Fortunately, there are several government and non-government initiatives to spur innovations and to shrink the innovation gap in these economies. For example, the Technology Agency of the Czech Republic (TACR) has been administrating the Innovation capacity 2014+ (INKA) project that maps the national innovation landscape. Based on this project, the TACR can identify demand for research results in the business sector – indicating what kind of research should be performed and which instruments of state support are most suitable. Moreover, the South Moravian Innovation Centre (JIC) based in Brno initiates cooperation between researchers and companies, which will be the way for the future. Sometimes these university-industry-government relationships are called "the Triple Helix",.

Besides supporting innovations, structural policies addressing the labor-market shortages and raising productivity are needed (e.g. expanding childcare, increasing incentives for business R&D, and reducing entry and exit barriers for firms). We cannot expect that Central European economies will change their model immediately, but they can create a business-friendly environment that will encourage adapting to future innovations and trends. /

Petr Teplý is an economist and lecturer at Charles University and University of Economics in Prague.

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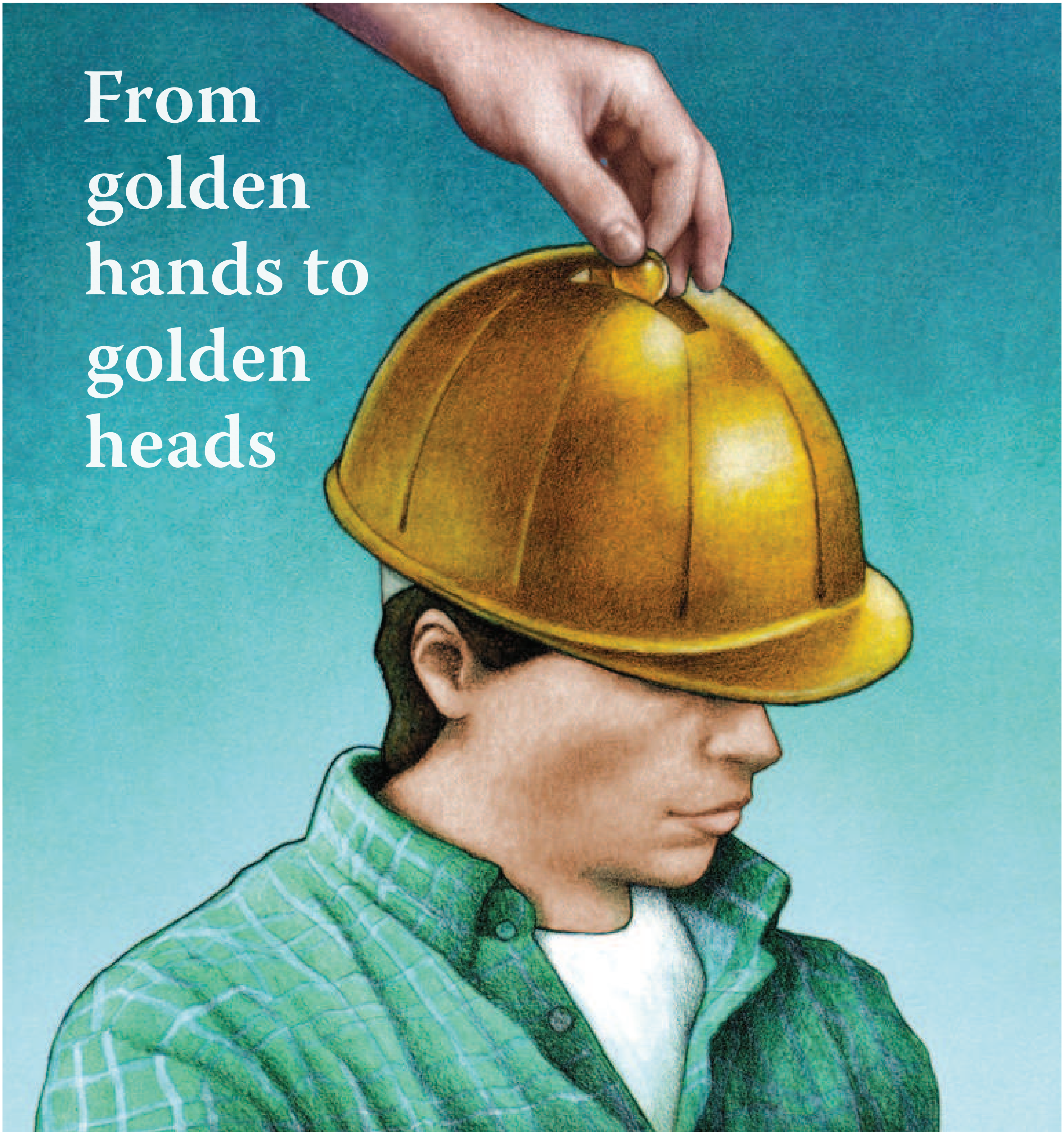

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