The Czech Economy and Europe

A 150-Year Overview

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The Czech Republic's Economy has undergone significant changes since 1867, the born of the Austro-Hungarian Empire. The World Wars transformed the structure of the economy over and over, and the shift to communism throughout Eastern Europe made socialist countries like Czechia rely heavily on the Soviet Union for markets, raw materials and energy. Due to the post-war economic boom after the Second World War, Europe experienced a significant economic expansion, and socialist countries in the Eastern 'Bloc' experienced higher growth rates in GDP than countries of the West in the „Golden Age of Capitalism".[i] *Eight days after the fall of the Berlin Wall, millions of Czechs and Slovaks filled the streets of Prague and the Communist Party stepped down. The parliament removed the one-party provision from the constitution (Velvet Revolution, Nov 17, 1989 – Dec 29, 1989).*

In 1993, the Czech Republic rejoined the International Monetary Fund (IMF), which played a key role in its transition to a market economy and in addressing banking issues in the early 2000s.[ii] *Although the Czech Republic wasn't among the countries most affected by the global financial crisis of 2008, its economy experienced a substantial year-on-year decline in real GDP throughout every quarter of 2009. However, Czech companies have shown a relatively high resilience to the effects of the financial crisis of 2008, while government measures to support the economy also proved to be efficient. The COVID-19 pandemic caused a 5.8% drop in GDP in 2020, with recovery slow in 2021, as the economy only reached 2018 levels. Even if 2021 marked a return to growth in most European Economies, the GDP of the country only reached the level of 2018. The annexation of Ukraine within a year after the global pandemic crisis further compounded economic uncertainties, like the decline in investments due to the uncertainties in the business climate in the region, rapid growth in energy and raw material prices, and many disrupted supply chains. By the end of 2022, inflation reached 18%, the highest since 1993.*

This summary captures the comprehensive economic overview of the Czech Republic's economy over the past 150 years, from the Austro-Hungarian Empire through the communist era to the present-day recession affecting the broader region of the Visegrad Four, including Hungary, Poland, and Slovakia.

The Czech Republic's Path to Market Economy

In 1867, the Austro-Hungarian Empire emerged, relegating Bohemia to an Austrian province and restoring direct administrative authority over Slovakia to Hungary. Czechoslovakia was created out of the parts of the Austro-Hungarian Empire after the First World War and declared independence in 1918. The western regions of the country, namely Bohemia and Moravia, inherited a significant portion of the Empire's industrial sector, whereas Slovakia remained predominantly agrarian.

Map of Czechoslovakia (1918-92), Encyclopedia Britannica, Inc. Accessed May 2, 2024. https://www.britannica.com/place/Czechoslovakia/images-videos

By the 1930s, Czechoslovakia became one of Europe's major industrial powers, having a strong heritage of craftsmen skilled in producing machinery and other manufactures. Incomes were high, and the well-developed economy had effectively established strong economic and political relations with the rest of Europe. In 1939, Germany proclaimed Bohemia and Moravia as a protectorate, while Slovakia gained autonomy as a separate republic under German influence. The economy endured difficulties under Nazi occupation, as a result of resource exploitation or forced labor. Following the Second World War, Czechoslovakia underwent a phase of economic recovery and resurgence, which was later disrupted by the Communist Party's takeover in 1948, and the one-party state was established. To deal with the financial consequences of the Great Depression[iii], the governments implemented restrictive macroeconomic policies to maintain domestic price stability and the international value of the crown. This 'fiscal conservatism' policy continued under the Communist regime as well, leading to a relatively low gross hard currency debt of 7.9 billion USD by 1989 (equivalent in purchasing power to about 192.7 billion USD today). The industrial market started lagging behind global standards, relying heavily on the Soviet Union for both markets and essential raw materials and energy. The breakdown of trade relations, especially with the USSR, resulted in input shortages and significant trade declines for many Czechoslovak firms engaged in all fields of heavy industry like machinery, consumer goods, and weapon production.[iv]

The post-war Czech economy was marked by declining growth rates, however, various external factors have influenced its performance, including the first oil shock in the 1970s and the subsequent debt crisis of the early 1980s. In response to the first oil shock, in 1975, the countries of the CMEA (the Council of Mutual Economic Assistance/Comecon) agreed to base all the export and import prices to global standards. This decision significantly inflated the costs of raw materials and fuels (major imports for Czechoslovakia) much more than those of manufactured goods. There was a similar turn in terms of trade in non-socialist countries, which widened the already wide gap in energy and raw material costs per unit of output between Czechoslovakia and Western Europe. As a consequence, trade deficits arose in all trading areas, although surpluses in services partly mitigated this tendency. Despite import constraints leading to shortages in consumer goods, the growth rate of consumption remained stable until the late decade. This was partially due to the protectionism and fixed trade pricing of the CMEA, which oil shock.

Since 1948, apart from cooperatives, small family businesses, and a relatively small number of farms, have been state-owned in Czechoslovakia, although the ownership of residential property was allowed. After the Second World War, major industries, banks, and insurance companies were nationalized without compensation to local owners and further nationalizations took place with the takeover of the Communist Party. Market mechanisms were entirely replaced by central planning, focusing on heavy industries and industrialization (First Five-Year Plan 1949-53). The period of liberalization in the late 1960s was short-lived, leading to a somewhat distorted economic prosperity accompanied by a Marxist-Leninist ideological miasma.

The revolutionary wave of 1989 and the fall of the Iron Curtain led to the collapse of the communist regime and the first free parliamentary elections in June 1990 paved the path towards democratic development and market economy. The unitary state was federalized and changed its name to the Czech and Slovak Federative Republic. The transition to a market economy was accompanied by the formation of distinct political institutions, with Slovakia often expressing aspirations for national independence. Following the 1992 elections, where parties with conflicting policies won in each part of the federation, the split of Czechoslovakia into two independent states (Czechia and Slovakia) became inevitable and stepped into force on January 1, 1993.[v]

Economic Resilience

In the late 1990s, the Czech Republic was in a systematic economic transition to become one of Europe's market economies while fighting currency problems and economic recession. In the years 2004-2008, the Czech economy's growth rate was more than twice as high as members of the Eurozone, which was mainly based on the increasing exports and import of labor productivity. Substantial foreign direct investment (FDI) encouraged trade integration, supporting an expansion driven by exports. However, despite the strong macroeconomic performance and stable banking sector, the Czech economy has been impacted by the spillover effects of the global crisis, primarily through the decrease in foreign demand.

The Czech economy's stability, as being a small open economy, heavily depends and relies on foreign demand, and it typically displays a high level of synchronization with other EU member states. Therefore, there was a high probability that the economic crisis would spill over to the Czech economy due to the expected decline in exports. Given the economy's close cooperation with the "old" EU Member States, external trade has been one of the primary channels through which the global economic crisis has affected the nation's economy. The reliance on industry, which bore the brunt of most of the impacts, led to a decline in industrial performance and dragged down the entire economy. The global financial crisis emerged fully in 2008, with initial indicators of the impending economic downturn appearing later in the Czech Republic compared to Western European nations. In the last quarter of 2008, the GDP growth compared to the same period the previous year only reached 0.5%. While Czechia wasn't among the worst-affected countries by the crisis, it still experienced a significant year-on-year decline in real GDP throughout every quarter of 2009 and didn't fully recover until late 2011 and 2012.

Between 2014 and 2020, after the period of prosperity, the Czech Republic managed to reduce its public debt to around 30 percent of GDP by 2019. This was mainly thanks to the low interest rates and simultaneous growth in nominal GDP. However, this contrasted with many Eurozone countries struggling to maintain their debt ratios below 60 percent of GDP, a level that was set as a safe upper limit. In 2020, similar to other countries in the world, the outbreak of the Covid-19 pandemic disrupted the fiscal and monetary balance in the Czech Republic. Extensive compensation measures were implemented during the first wave with the hope, that maintaining the strong demand can help avoiding the demand crisis experienced in 2008-2009. By the end of 2020, it became evident that the situation evolved differently, and demand remained robust due to substantial public spending. The Budget Responsibility Act[vi] notably softened the fiscal rules for the structural deficit and consequently ensured the stability of public finances.[vii] Undeniably, every industry was affected by the pandemic with different forces.

An important aspect of economic resilience is energy security. The energy crisis caused by the Russia-Ukraine war was the end of the era of cheap oil and gas and rearranged the geopolitical order around raw materials and energy. The outbreak of the war interrupted the incoming coal, oil, and gas supplies to the region, challenging the Visegrad Four group's ability to cope with geopolitical disruptions. The energy policies in Central Eastern Europe - particularly between the Visegrad Four countries - show a lot of similarities, such as their deep-rooted preference for nuclear energy, which has been the cornerstone of regional energy strategy. The energy dependence of the region dates back to the Cold War period. This dependency affects the current position of the V4 and Czechia in the new geopolitical order that was born because of the war in Ukraine, especially within the context of the European Union. The push from the EU and other global NGOs to increase the use of renewable energy is creating further controversies in political and economic debates all over the region.

There are additional considerations regarding the potential success of the enlargement, given that it would increase the number of member states from the Eastern part of continental Europe and put more pressure on the economies of the region. The Czech Republic views EU enlargement as a strategic opportunity to enhance regional stability, resilience, and economic growth in the region. President Petr Pavel underscored the geostrategic necessity of integrating the Western Balkans, Ukraine, Moldova, and Georgia into the EU, stating the economic benefits of expanding the Union's market. For Czechia, the enlargement is an economic interest, and often say that "their accession to the Union showcases the reason why countries should join this success story". The Czech leadership is the biggest advocate of enlargement politics thus rooted in the belief that a larger, more integrated European market would pave the way to collective economic resilience and prosperity.

The Czech Economy and Europe

The Czech Republic's economic growth significantly slowed down following Russia's war in Ukraine, reflecting disruptions in global supply chains, notable rises in energy and commodity prices, decline in wages, and necessary monetary policy adjustments. Growth is anticipated to rebound in 2024, primarily driven by increased consumption and fixed investment, as inflation recedes and real incomes begin to rise again, supported by a necessary tightening in monetary policy.

Foreign Direct Investment (FDI) flows fell to 5.8 billion USD in 2021 from 9.4 billion USD, which means a 38.8% drop compared to a year before. The country, however, is still ranked among the largest recipients of FDI inflows in Central Eastern Europe. EU member states are the primary foreign investors in the Czech Republic, which includes the Netherlands (23.5%), Luxemburg (16.8%), Germany (16%), Austria (14.9%) etc. Regarding economic activity, the financial and insurance sector constitutes 28.3% of the total inward Foreign Direct Investment (FDI) stock, followed by manufacturing with 27.1% (mainly the automobile industry), 12.2% of wholesale and retail trade, and real estate with 9.4%.

As the EU market holds a significant share of total Czech exports, the Czech economy is heavily dependent on the stability of its trading partners. Approximately 70 percent of the Czech exports are directed towards other EU member states, with Germany accounting for 26 percent of its total, serving as the Czech economy's primary trading partner. In 2008, Germany was already the Czech's major trading partner, receiving 30.8% of its exports. This tendency remained consistent, standing at 33.8% in 2022.

Following Germany, China has become the Czech Republic's second-largest goods supplier and trading partner, with trade in goods to China amounting to 2.6 billion USD in 2023. The country runs a huge (and constantly growing) trade deficit with China both in goods and services and aims to increase the total export volume of services by 20% in the future. Given that the Visegrad Four (V4), which includes the Czech Republic, holds significant importance within the Belt and Road Initiative, China's economic and political interactions with these nations should be considered in its relations with the European Union. China's interest in the Visegrad Four derives from their membership in the EU, as they are capable of influencing European politics, particularly policies regarding China. Although this is a sort of multilateral engagement, which makes possible an alternative channel for China to regularly communicate with EU members, these dealings with V4 countries primarily occur through bilateral projects. The contrast between apparent multilateralism and actual bilateralism is evident in the slow process of multilateral projects like the modernization of the Belgrade-Budapest rail line within the framework of the "17+1" initiative.

In terms of GDP per capita, the Central and Eastern European countries are among the most developed countries. According to the United Nations Industrial Development Organisation (UNIDO), the Visegrad Four countries belong to the 30 most competitive manufacturing exporters globally. It's fair to conclude that the Czech Republic is a regional leader, whose GDP was 92% of the EU average in purchasing power parity and constancy in prices in 2021. One of the drivers of this massive growth in the region, is the success story of the well-educated and cooperatively price-competitive workforce, making the percentage of highly skilled workers among the total of employees in CEE-EU countries just as high as in Western European countries. The pace of growth closely correlates to the openness of the Czech market to the global economy, and access to the European single market is a key factor in living up to its full potential on a global level. The European Union's driving reforms are essential for the Czech economy to continue growing as it creates opportunities for products and services that result in growth and FDI inward stocks. In the aftermath of the global pandemic, nearshoring and reshoring of global supply chain decisions became a more important factor than ever. The pandemic's disruptions to global supply chains forced manufacturers to rethink their logistics models. The countries of the region well positioned themselves in this situation, with Czechia on the podium. Czechia became the top-ranked country for nearshoring, not just in the CEE region but also in the world, with Poland ranked 9th and Hungary 15th. Economically the V4 countries have become vital hubs for manufacturing and trade within the Union, contributing a mass to the EU's overall competitiveness. Further integration of the V4 in the Union's Single Market is in the interest of the Union itself, as more openness raises incentives for productivity improvements and raises the output by as much as 7 percent in the long run. With open and harmonized regulations and streamlined trade procedures the EU can further lower its business costs and the further integration of countries like Czechia could increase trade and income by a proximity of 1.6 percent.

The strengthening of the Single Market in the region would stimulate growth and enhance resilience while counteracting geoeconomic fragmentation caused by the war in

Ukraine and the global pandemic. It is a general tendency in the global economy that Europe's major trading partners are adopting inward-looking and protectionist policies, partly as an answer for the complex geopolitical challenges and their economic impacts. It would also be essential for Europe to respond by lowering its internal barriers and fully leverage the potential of its expansive market. Europe is in a unique position among the major economic blocs. While the United States excels in innovation and China in manufacturing, Europe proved to be able to serve as a hub for both of these areas. Europe is a hub for innovation and offers affordable manufacturing locations, thanks to its Eastern member states. This dual feature of the market is largely because of the CEE region and equips the Union with a distinct advantage that has to be used more than it's being used right now. This further integration of Czechia and other countries of the region such as the V4, not only solidifies the region's role in the broader EU economy, however, it also contributes to the collective strength of the EU, capitalizing on Europe's unique position to foster innovation and competitive manufacturing.

Conclusion

The Czech Republic's transition from part of the Austro-Hungarian Empire to an independent state marked the beginning of its economic evolution and rise. The collapse of the communist regime in 1989 ushered in a new era of democracy and market economy, paving the way for the Czech Republic's integration into the global, but most importantly European economy. In the early 2000s, the nation experienced massive economic growth, driven by increasing imports and demand, and foreign direct investments. This period of prosperity bolstered the country's position within the European Union and placed the country in a good position in the global economy. While not among the most affected countries, the Czech economy went through a significant decline in real GDP throughout 2008 and 2009, demonstrating its vulnerability to external shocks, particularly to the lack of external demand. As a member of the European Union and the second-largest economy of the Visegrad Group, the Czech Republic plays a crucial role in shaping EU-China relations, especially given its bilateral economic and political participation in projects like the Belt and Road Initiative. Looking ahead, the Czech economy confronts fresh challenges deriving both from the East and *the West. Given Central Eastern European openness and substantial human and economic potential, it is not a wonder that the countries of the region have already become a rising hub for nearshoring business services. Countries of the CEE region, particularly the V4 countries, are on the right path to establishing themselves as key economic players in Europe, exemplified by their remarkable GDP per capita and manufacturing export capabilities. The Czech market's openness to the global economy and access to the European single market have been critical to this growth and the post-pandemic shift towards nearshoring further enhanced the region's appeal. Europe's unique position as a hub for both innovation and affordable manufacturing - thanks to its Eastern member states - offers a distinct advantage. Further integration of Czechia and other V4 countries would not only solidify the region's role within the broader EU economy but also enhance the collective strength of the Union, capitalizing on Europe's ability to foster both innovation and competitive manufacturing.*

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[iii] Czechoslovakia was greatly harmed by the Great Depression and from the pre-crisis peak in 1930 to the worst moment in 1933 when measured in the Czechoslovak currency (crowns), the Czechoslovak industry collapsed by a staggering 40% (the problems started in the agricultural sector).

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