



DRIVERS OF GROWTH

ECFIN Country Workshop

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Executive summary

Convergence of the Czech Republic's GDP per capita to the EU average was slower than expected twenty years ago. Moreover, net national disposable income, a proxy of living standards, has not improved relative to the EU-15 average. This presentation puts forward four elements that help explain these facts.

Firstly, growth in CZ as well as in other CEE countries was largely driven by foreign direct investments – an appropriate choice for countries that needed to recapitalise and catch up with the technological frontier. However, despite numerous success stories, the evidence that FDI helped improve the overall sophistication of production, which is the crux of long-term growth, is mixed. Secondly, this growth model produced impressively low unemployment. While this was an achievement envied by many, it perhaps also took away the pressure to continue with reforms. The Czech Republic started to lag behind on the quality of the institutional framework. Since institutions ultimately shape growth, this is a serious issue.

Zooming in on the post-crisis period, two additional factors account for the observed growth differentials between CZ and its regional peers: As the strong post-war cohort approached retirement, the Czech population of working age started to shrink. Projections suggest that demography is to become a permanent drag on growth. Finally, while fiscal consolidation was necessary and of broadly comparable magnitude e.g. with SK, the particular mix of the Czech fiscal adjustment resulted in a higher drop in GDP.

Based on this analysis, we draw a list of reforms that could strengthen domestic drivers of growth.

1989

“We will reach Austria in 10 years”

Valtr Komárek

economist and politician (1930-2013)

1997

"In 2-3 years real GDP growth should be back at 4-5% again. We should reach the EU in about 20 years"

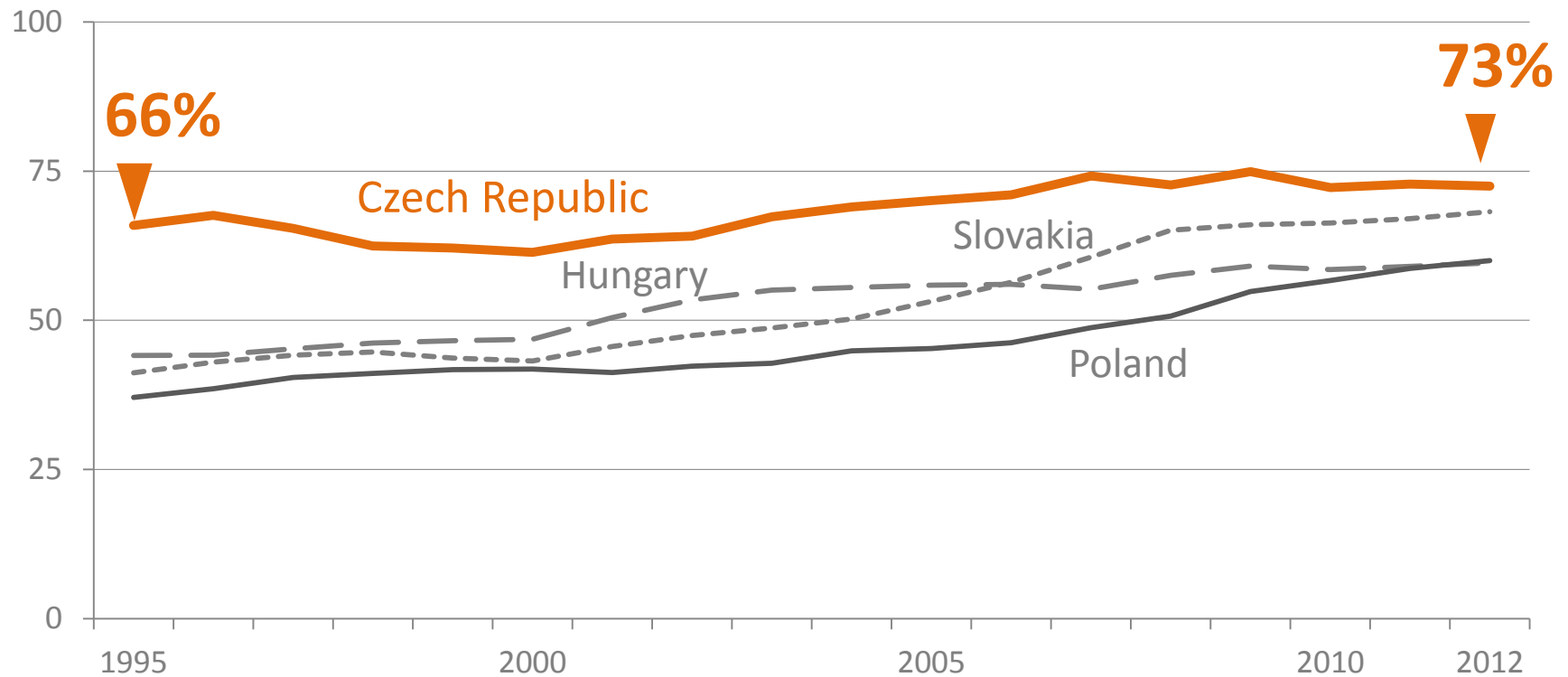
Zdeněk Tůma
former Governor of Czech National Bank

"We could get at the EU level in a medium-term horizon, in around 10-15 years"

Eva Zamrazilová
member of the CNB Bank Board

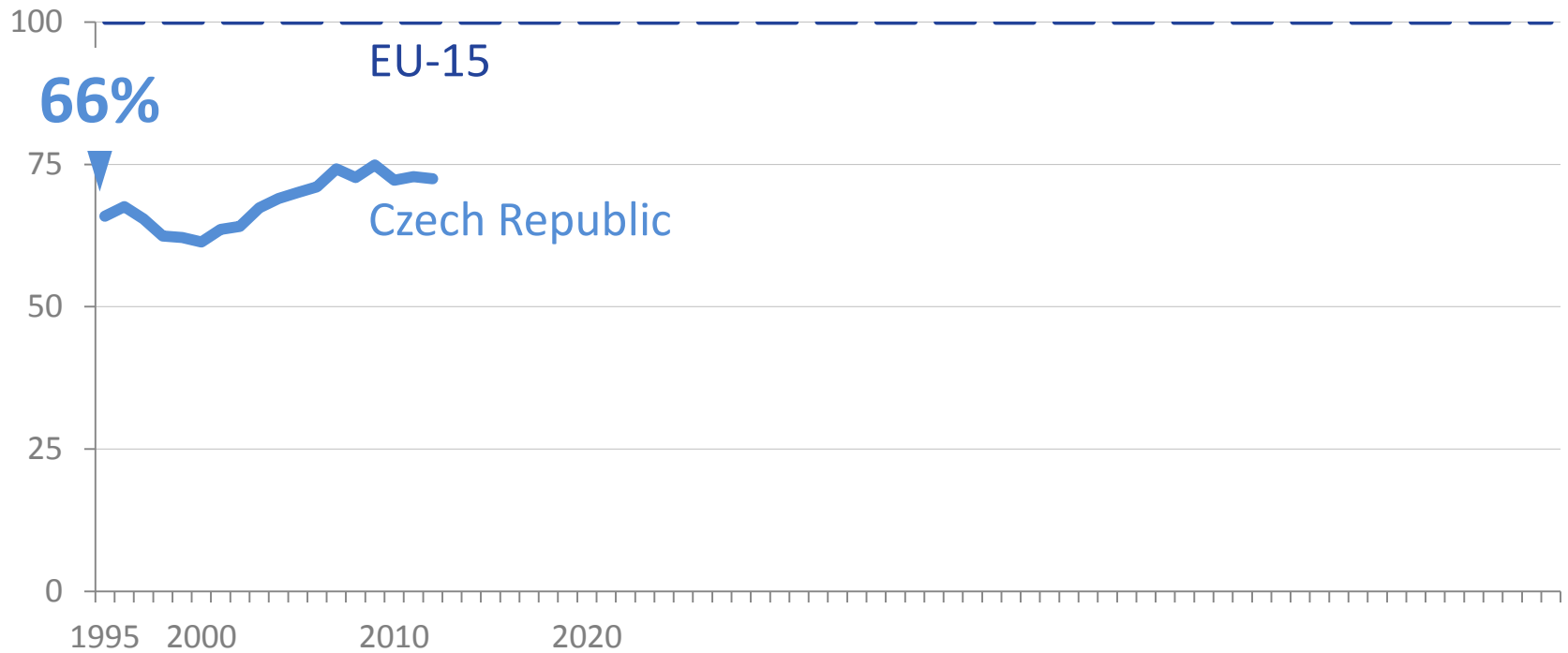
Reality: Not there yet

GDP/capita relative to EU-15, in %



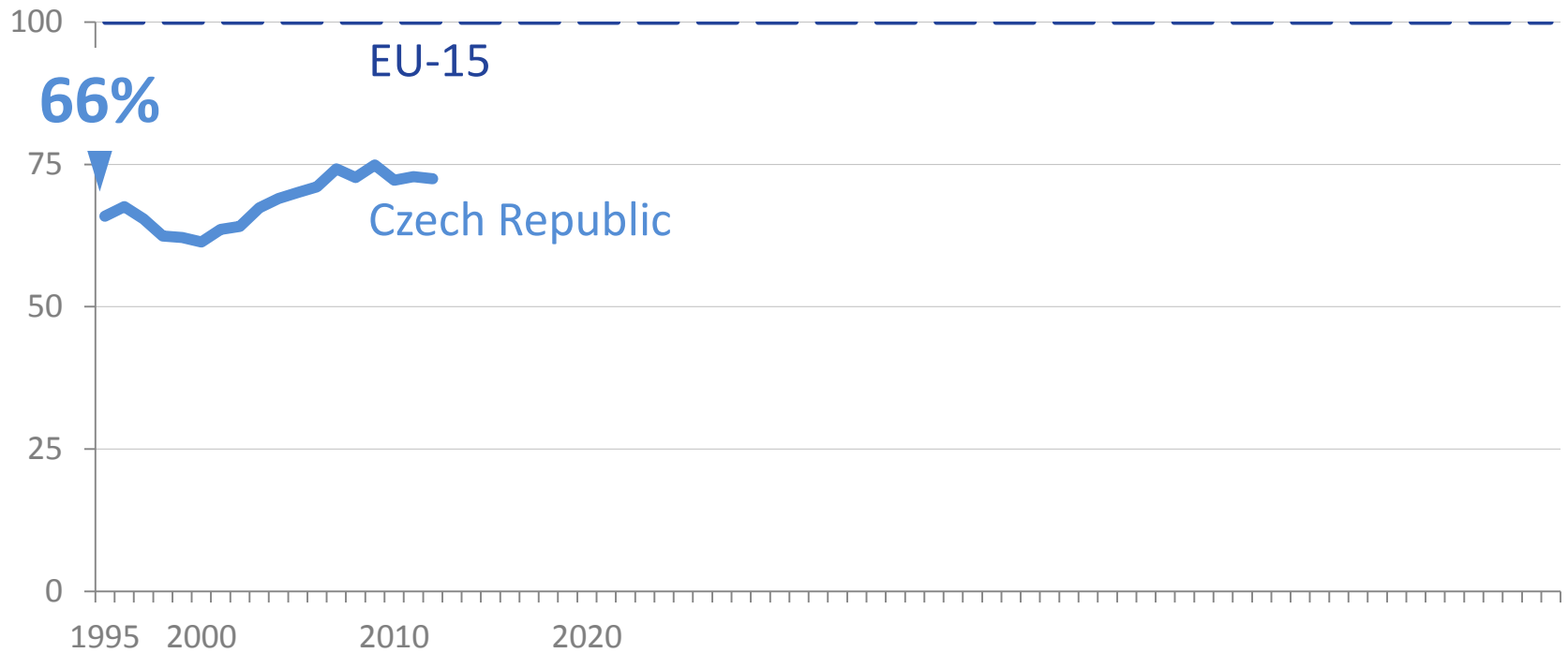
At this speed, convergence with EU-15?

GDP/capita vs. EU-15, in %



At this speed, convergence with EU-15?

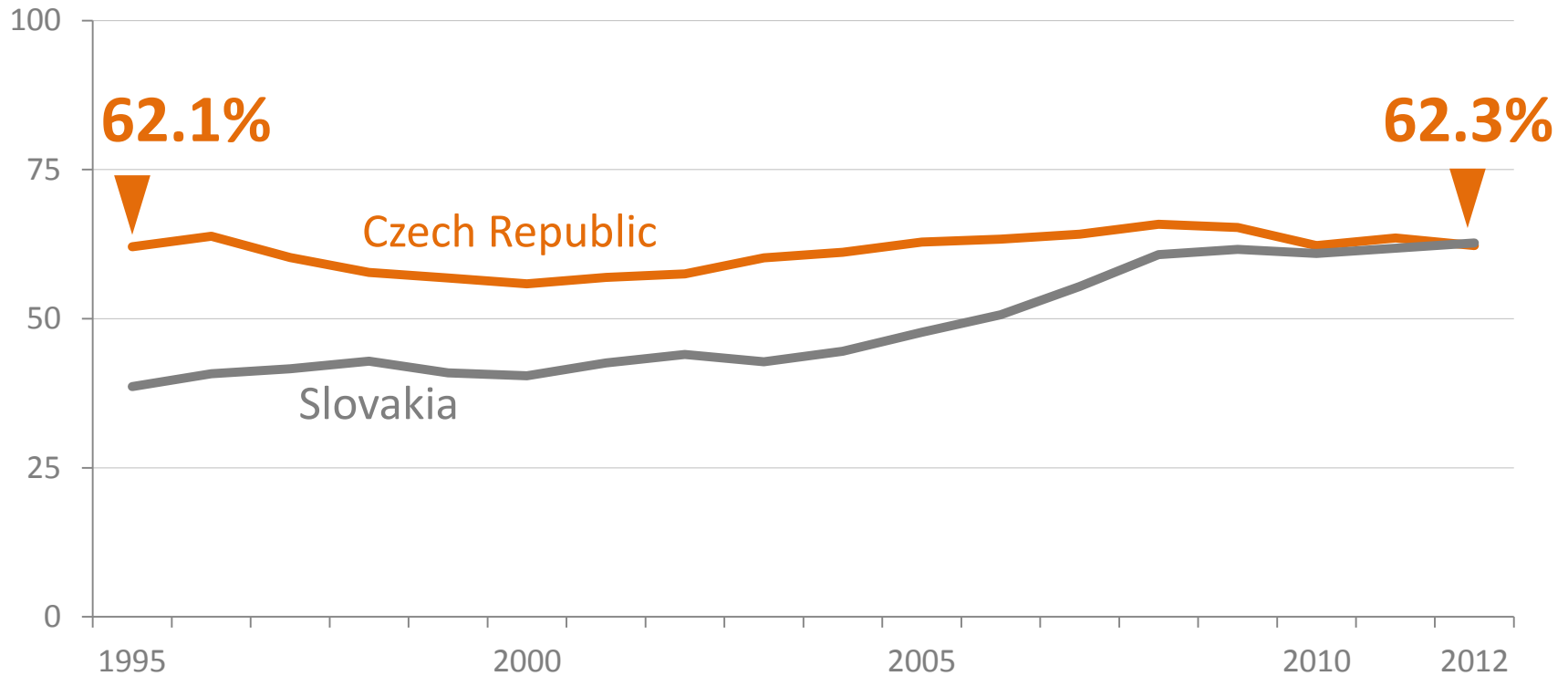
GDP/capita vs. EU-15, in %



Looking at what really matters

Living standards

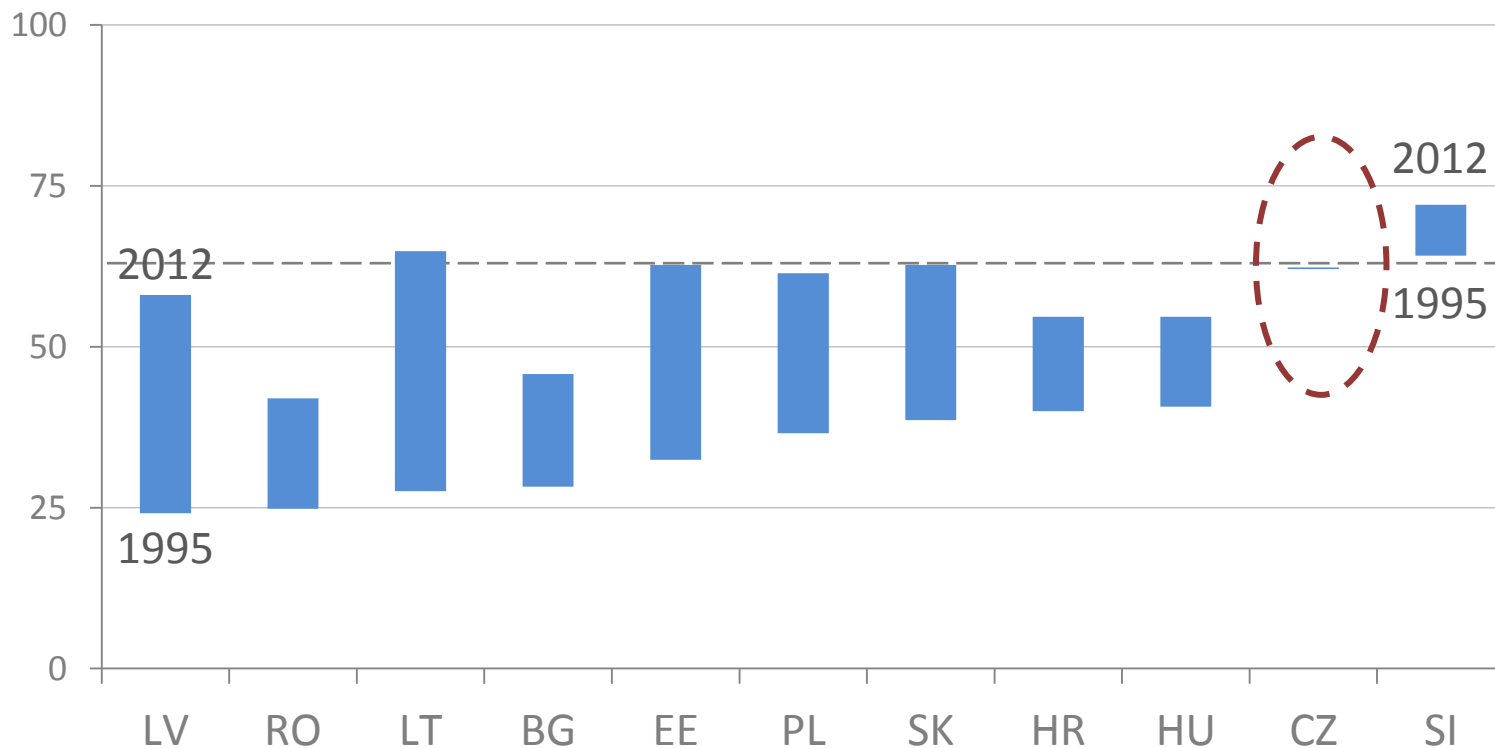
Net national disposable income in % of EU-15



Only in CZ did convergence in living standards stall

Change in livings standards 1995-2012

Net national disposable income in % of EU-15



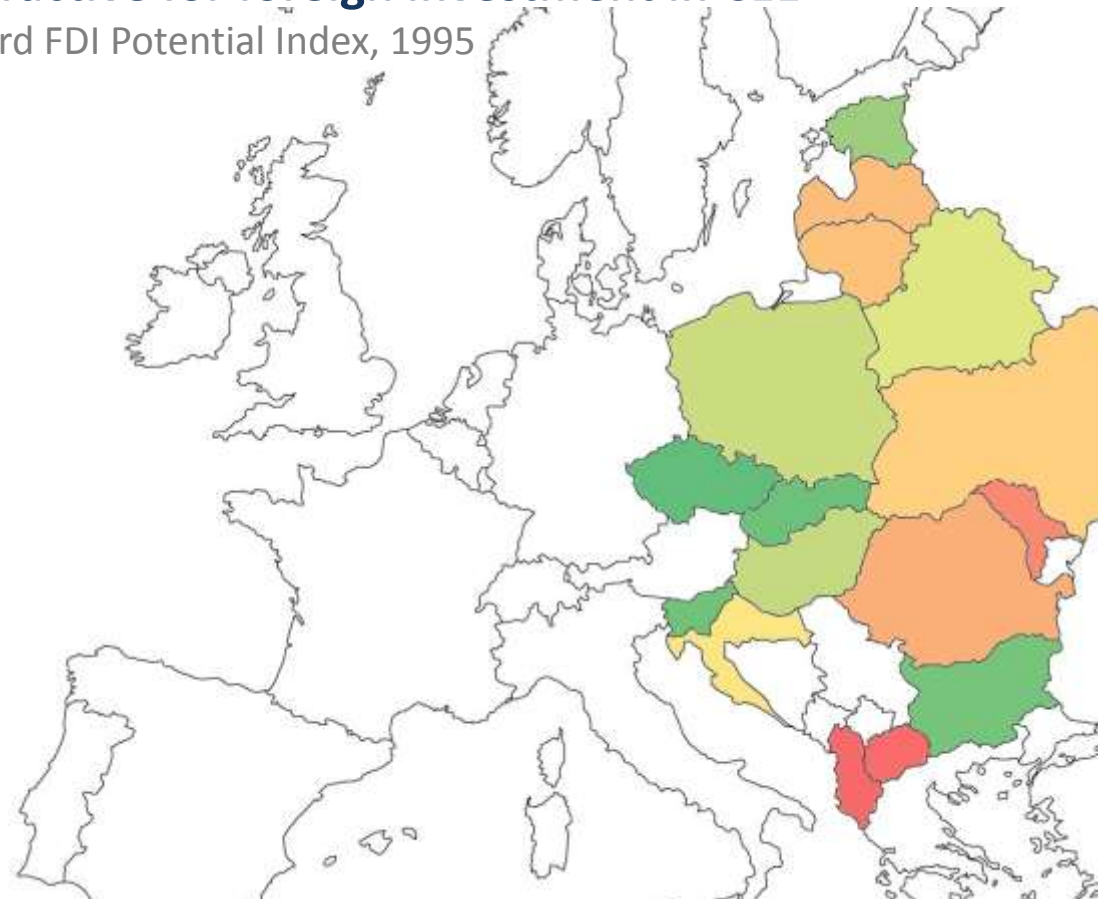
What happened?

- 1 FDI / export driven development**
- 2 Institutional framework
- 3 Demographics & labour supply
- 4 Consolidation mix

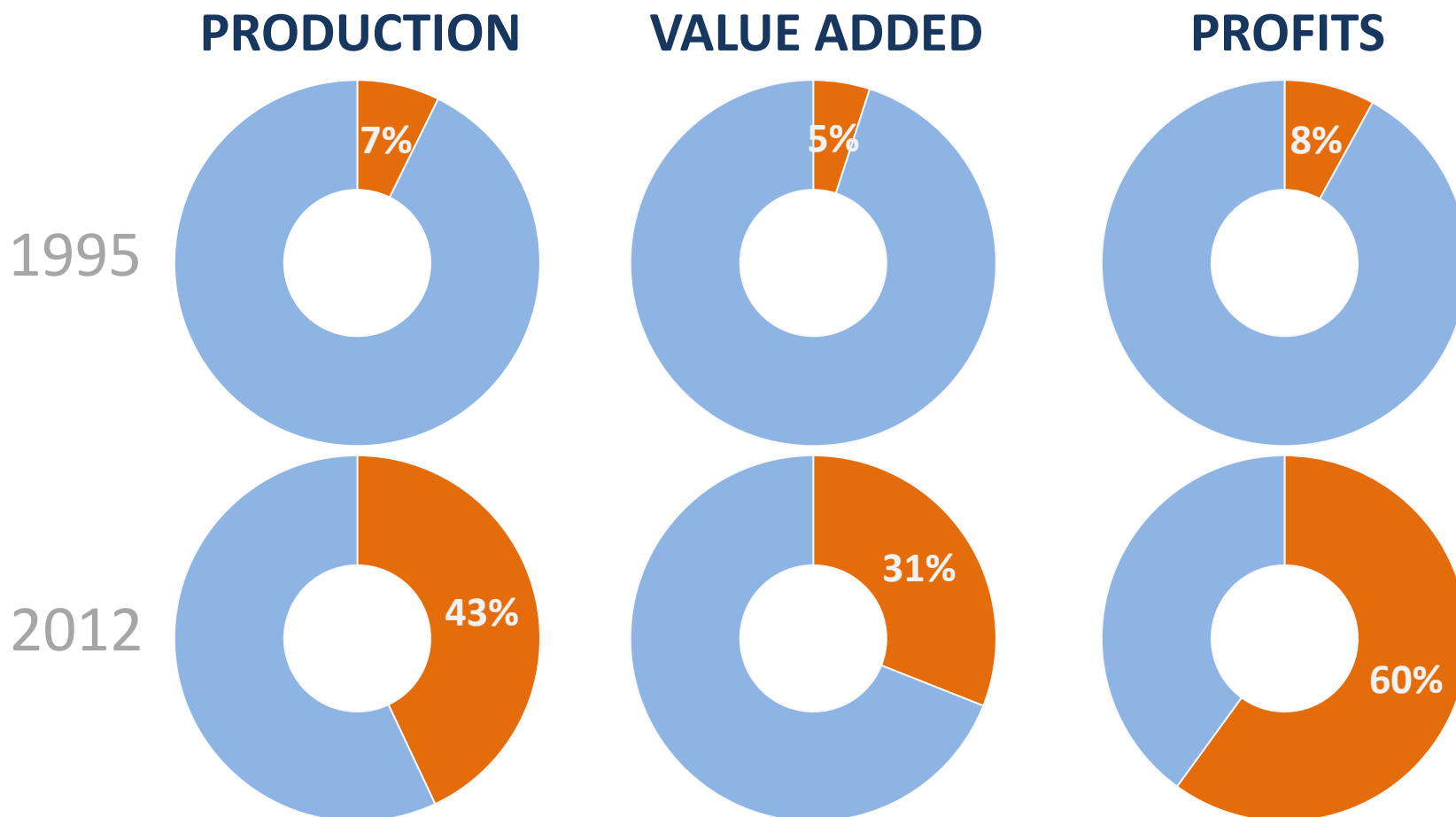
CZ was highly attractive for FDI

CZ most attractive for foreign investment in CEE

UNCTAD, Inward FDI Potential Index, 1995



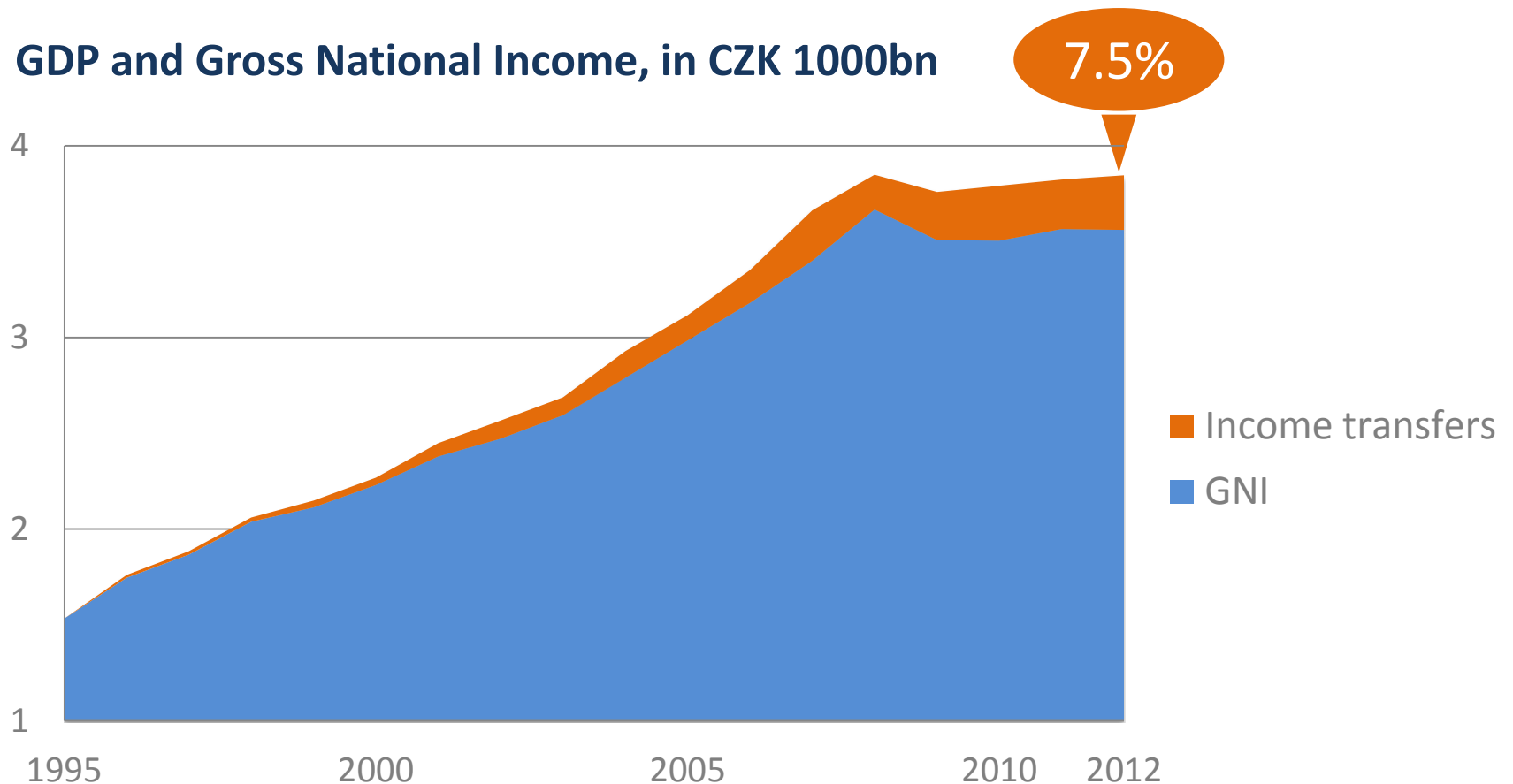
Today, FDI shape CZ economy...



Source: CzSO (2012)

...and induce large income transfers

Income transfers account for 7.5% in 2012



Know

how

transfers?

Shifting to knowledge-intensive output

Picture mixed

Ranking of CZ among EU-28 Member States

4

EMPLOYMENT IN HIGH-TECH MANUFACTURING

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MEDIUM & HIGH-TECH PRODUCT EXPORTS

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BUSINESS R&D

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PATENT APPLICATIONS

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SCIENTIFIC PUBLICATIONS

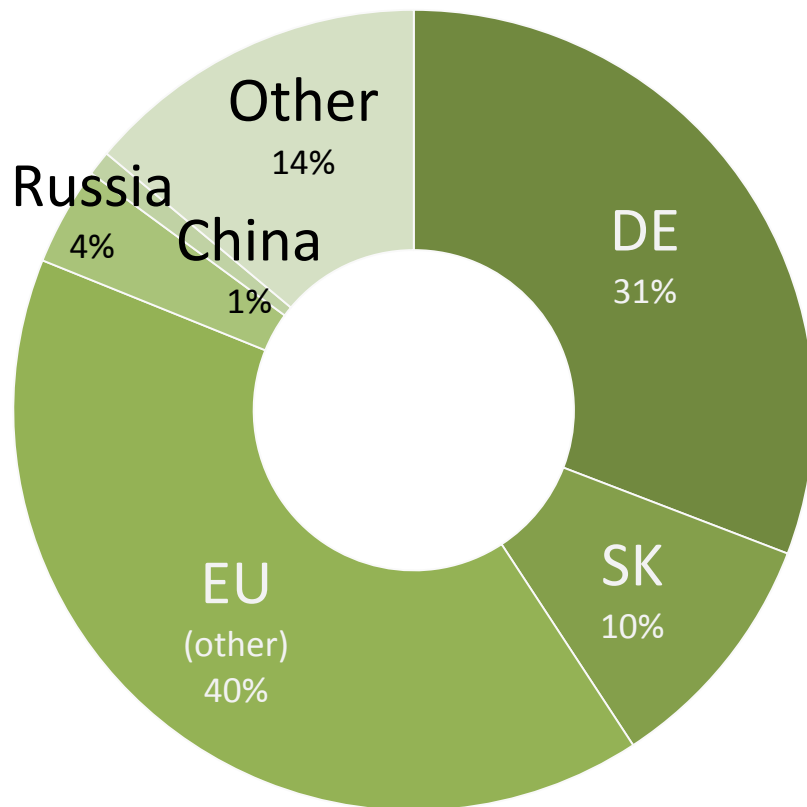
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EMPLOYMENT IN KNOWLEDGE SERVICES

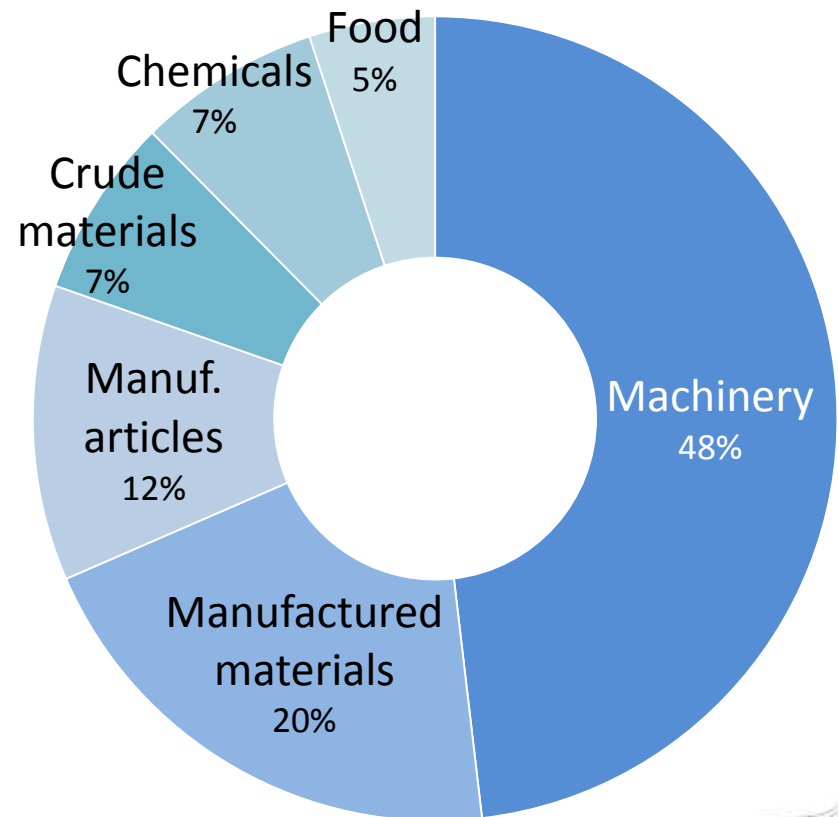
CZ economy export-oriented

But exports highly concentrated in terms of geography and structure

WHERE DOES CZ EXPORT TO?



WHAT DOES CZ EXPORT?



FDI/export model: What to expect

More FDIs?

More external demand for current products?

Shift in value added?

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CZ falling behind in governance...

CZ underperforms most EU countries in governance

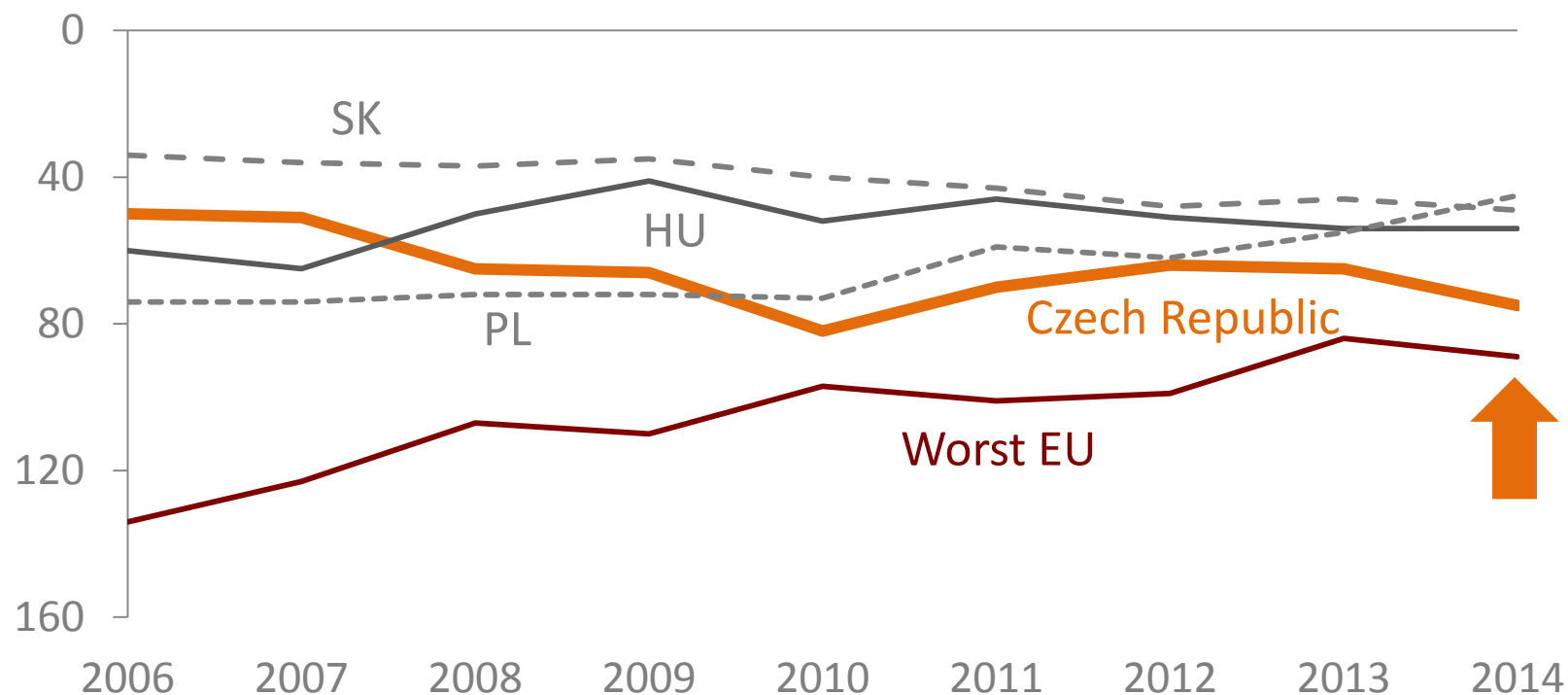
Ranking of CZ vs. EU-28 MS, 2013

KEY INDICATORS	RANK
Political Stability	7
Regulatory quality	16
Law	17
Government Effectiveness	18
Voice & Accountability	20
Corruption	21

...and business environment

WB Doing Business country rankings

1=best in the world, 189=worst in the world, 89=worst EU MS in 2014



Labour is heavily taxed

Taxes on labour higher compared to peers but also Germany

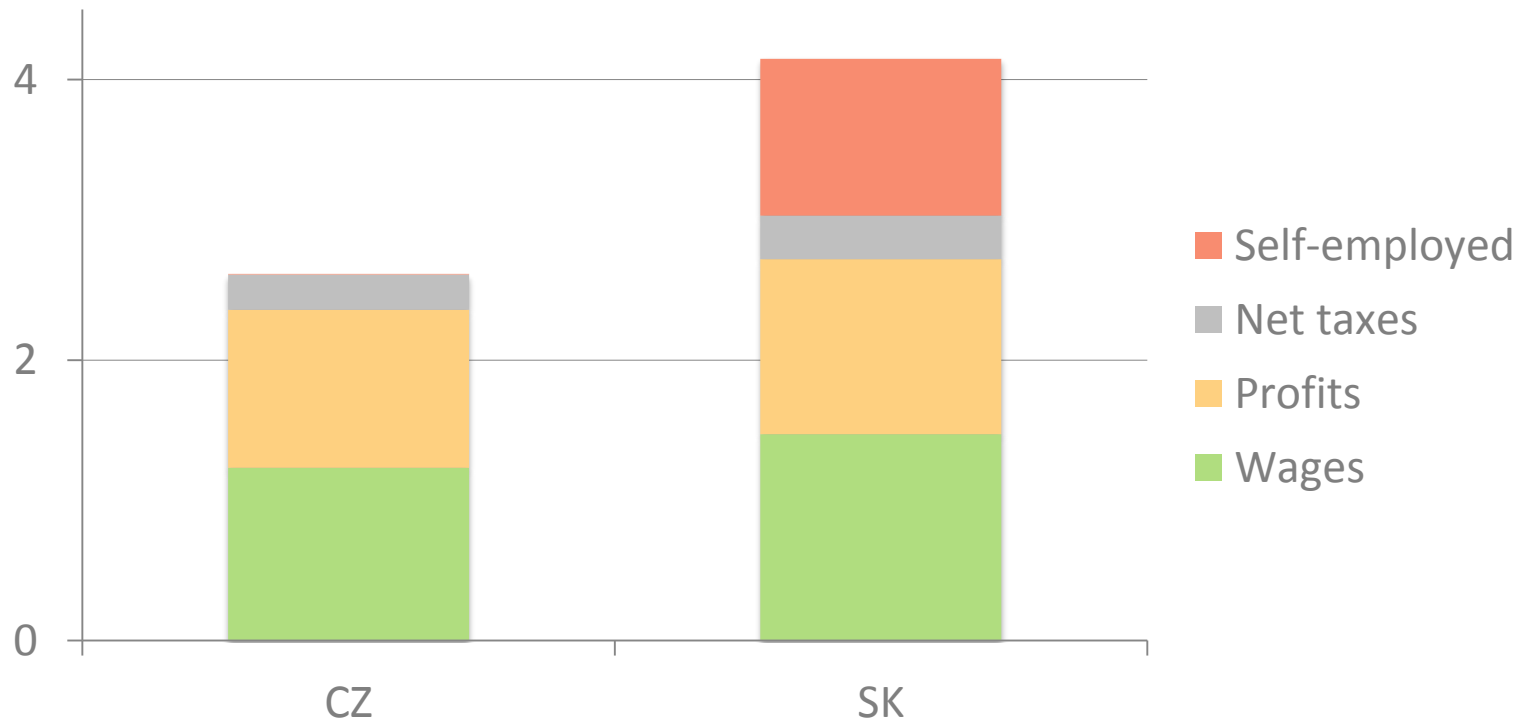
Implicit tax on labour, in %, 2011

	TAX (%)	RANK
BE	42.8%	1
IT	42.3%	2
CZ	39.0%	6
DE	37.1%	10
PL	32.2%	16
SK	31.9%	19
BG	24.6%	26

Taxes affect employment status

Shares of self-employed increased in both CZ and SK
but CZ self-employed made zero contribution to GDP growth

Average contribution to GDP growth, in %, 1995-2012

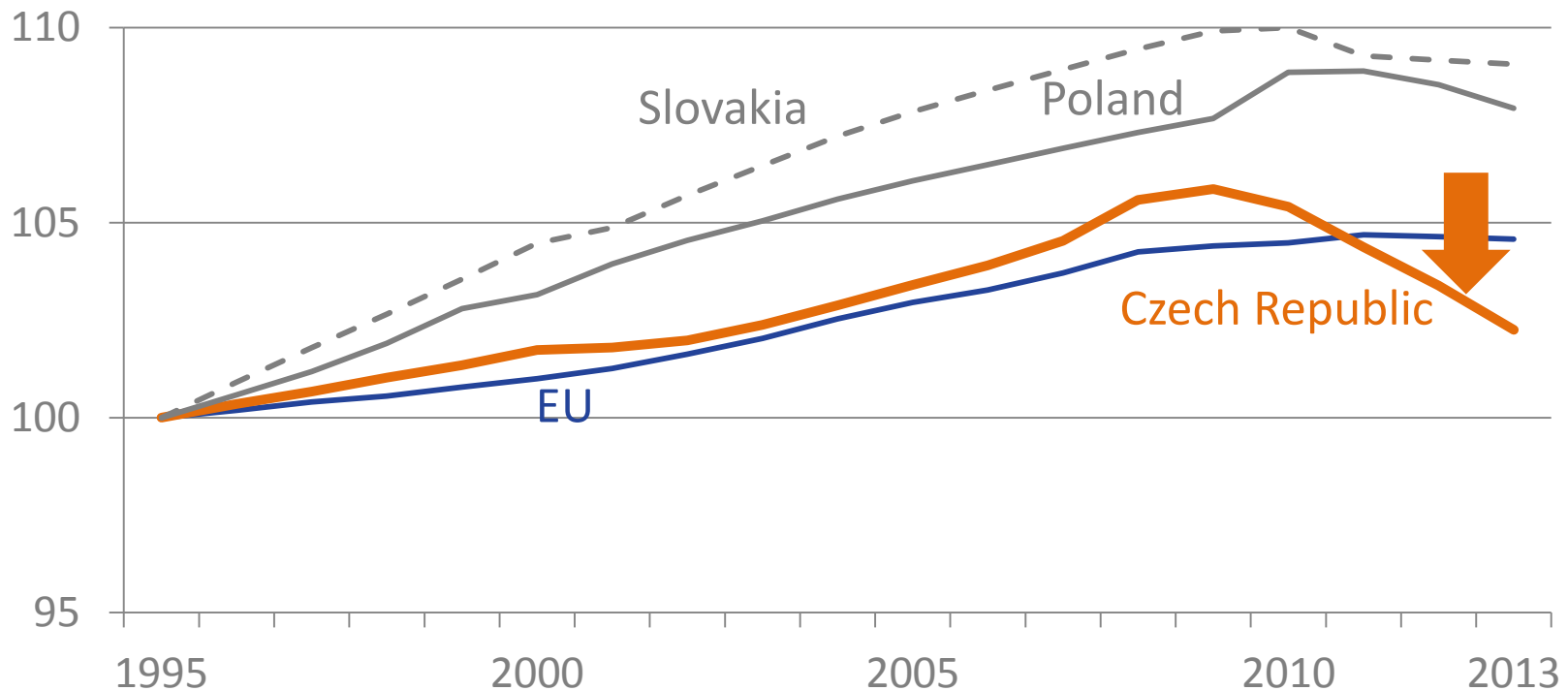


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Working age population is now shrinking

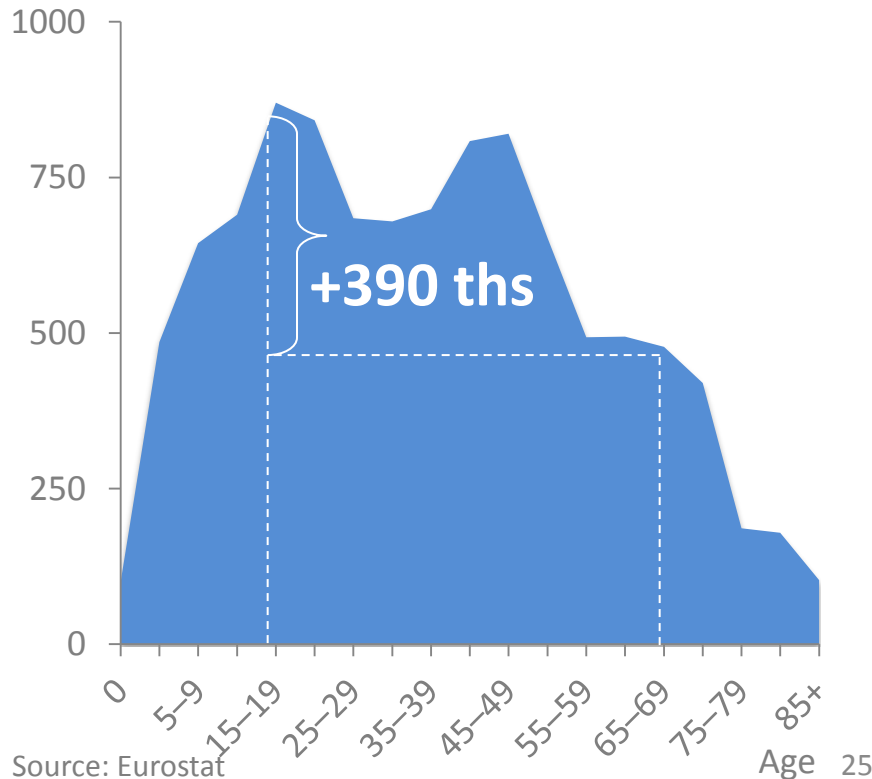
Number of people aged 15-64 years



Ageing plays a role

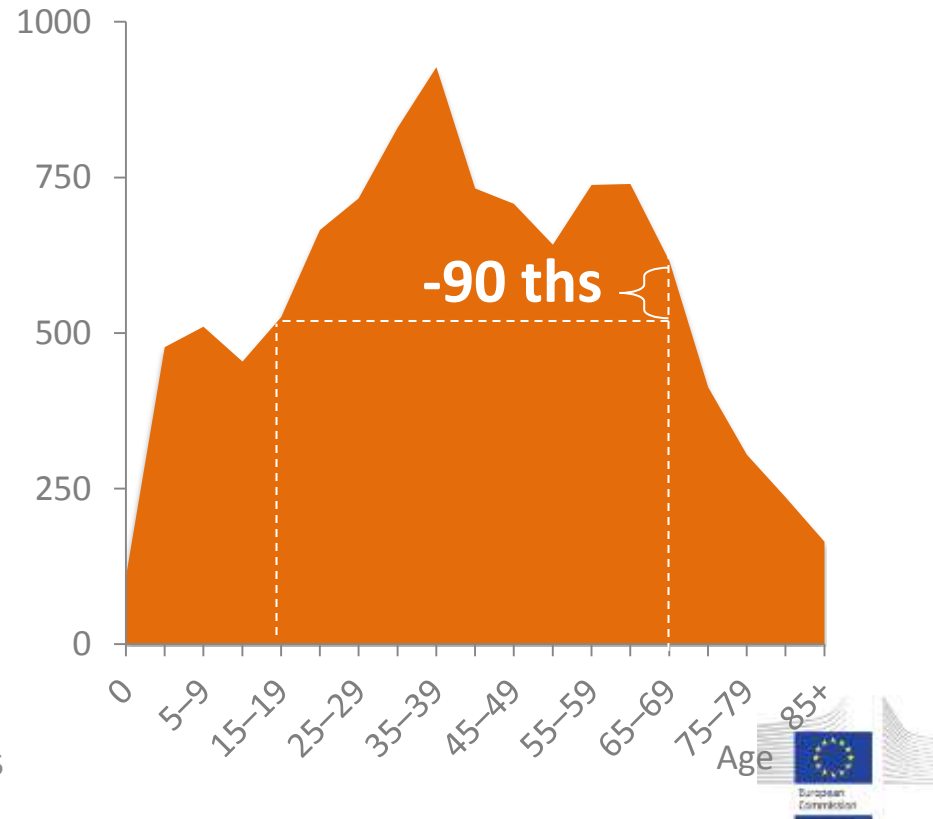
1995

Working age population,
1995 (in ths)



2012

Working age population,
2012 (in ths)



Utilisation of labour has been a strength

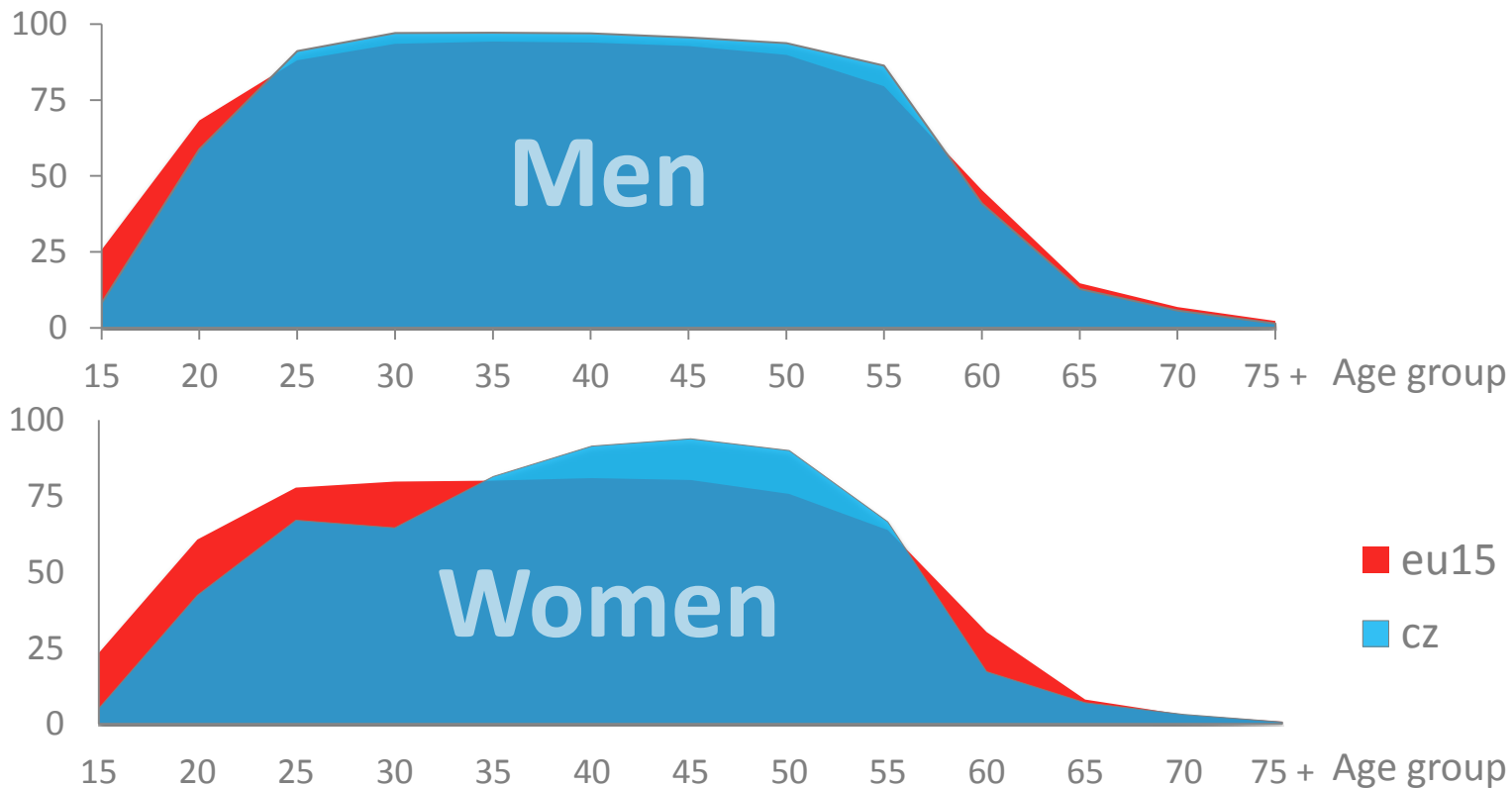
Gap to EU-15, average 1995-2012

	GDP/capita	Overall productivity	Labour utilisation
CZ	69%	57%	121%
SK	55%	56%	98%
HU	54%	48%	113%
PL	48%	44%	108%
EU-15	100%	100%	100%

Labour participation of young women much below EU-15

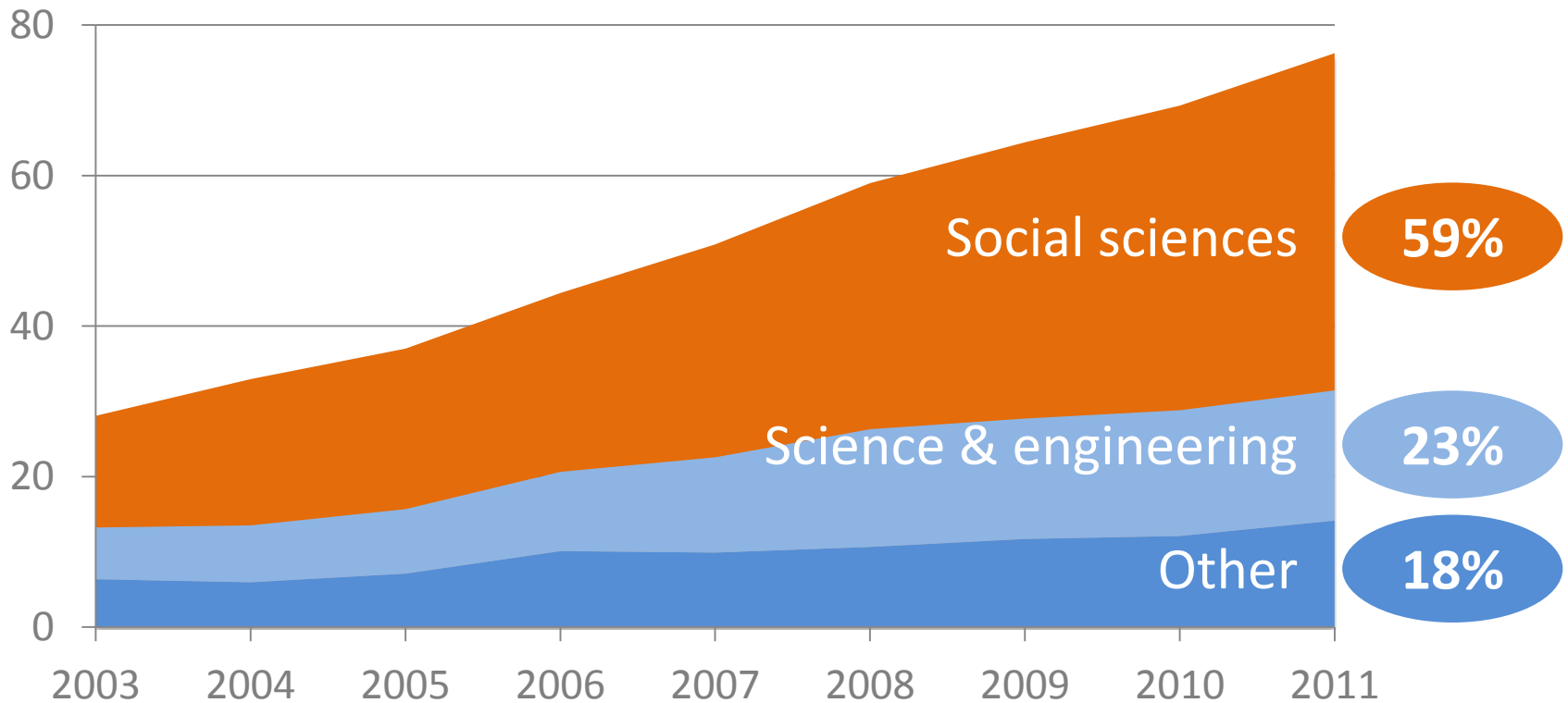
Underutilised potential in the labour market

Employed and unemployed on population, in %, 2012

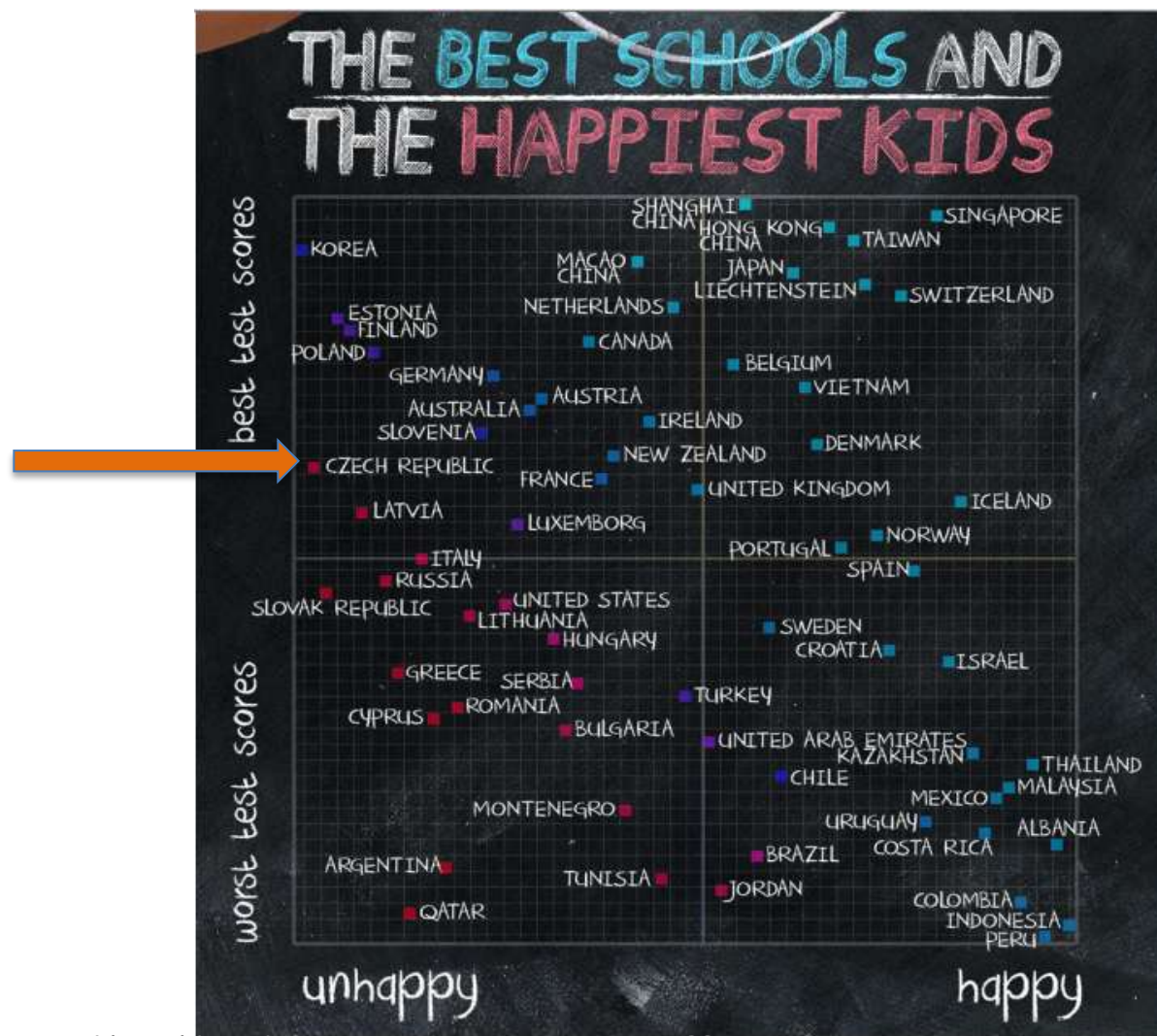


Unprecedented expansion of higher education – but is the structure right?

CZ graduates by field, in ths



Unused potential in primary education



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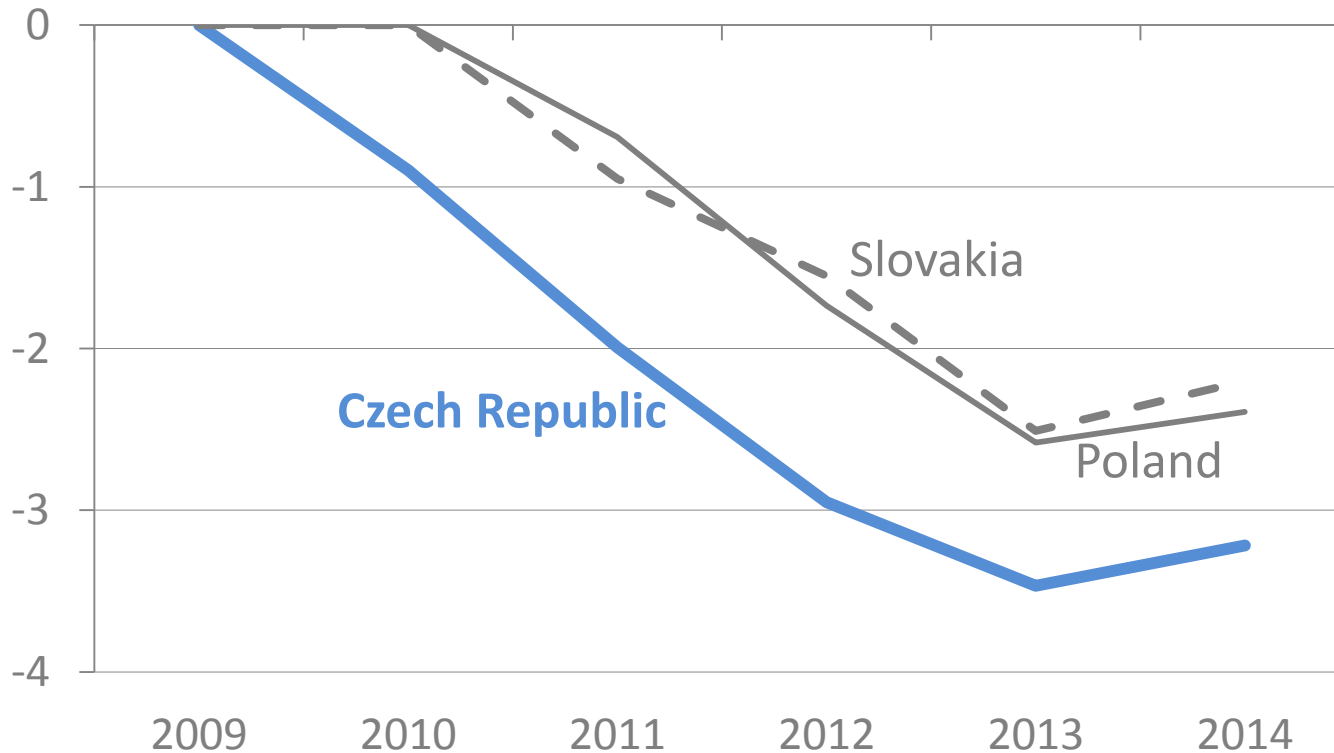
Fiscal effort 2010-2013

Cumulative discretionary measures, in % of GDP, 2010-2013

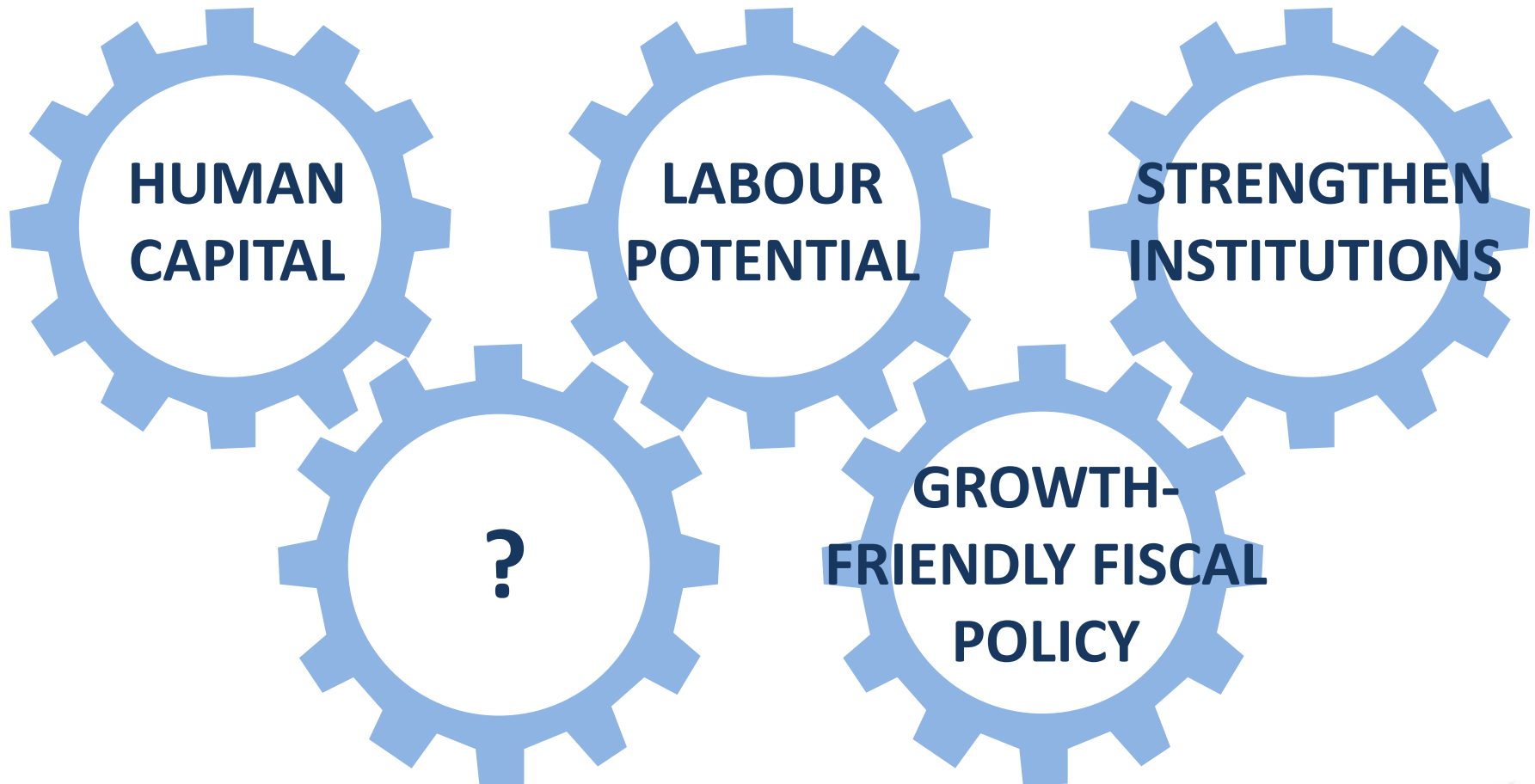
	CZ	SK	PL
TOTAL REVENUE MEASURES	1,6	2,2	0,4
Indirect taxes	1,4	1,1	0,2
Personal income tax	0,1	0,1	0,0
Corporate income tax	0,0	0,2	-0,3
Social security contributions	0,1	0,7	0,5
TOTAL EXPENDITURE MEASURES	3,1	2,4	3,3
Intermediate consumption	0,6	1,2	0,5
Compensation of employees	0,4	0,5	0,4
Social benefits	0,1	0,0	0,8
Public investment	1,9	0,7	1,6
TOTAL DISCRETIONARY MEASURES	4,7	4,6	3,7

Consolidation resulted in disproportionately higher drop in GDP

Cumulative loss in % of GDP, 2010-2013



Way forward: Stimulate domestic drivers of growth



Way forward: Rebalance to domestic growth

(Detail based on 2013 Country-specific Recommendations)



HUMAN CAPITAL

- Improve quality of education (all levels)
- Support innovations



STRENGTHEN INSTITUTIONS

- Reduce tax compliance costs
- Address self-employed - reduce discrepancies
- Anticorruption strategies / improve administration



UTILISE LABOUR POTENTIAL

- Increase child-care facilities



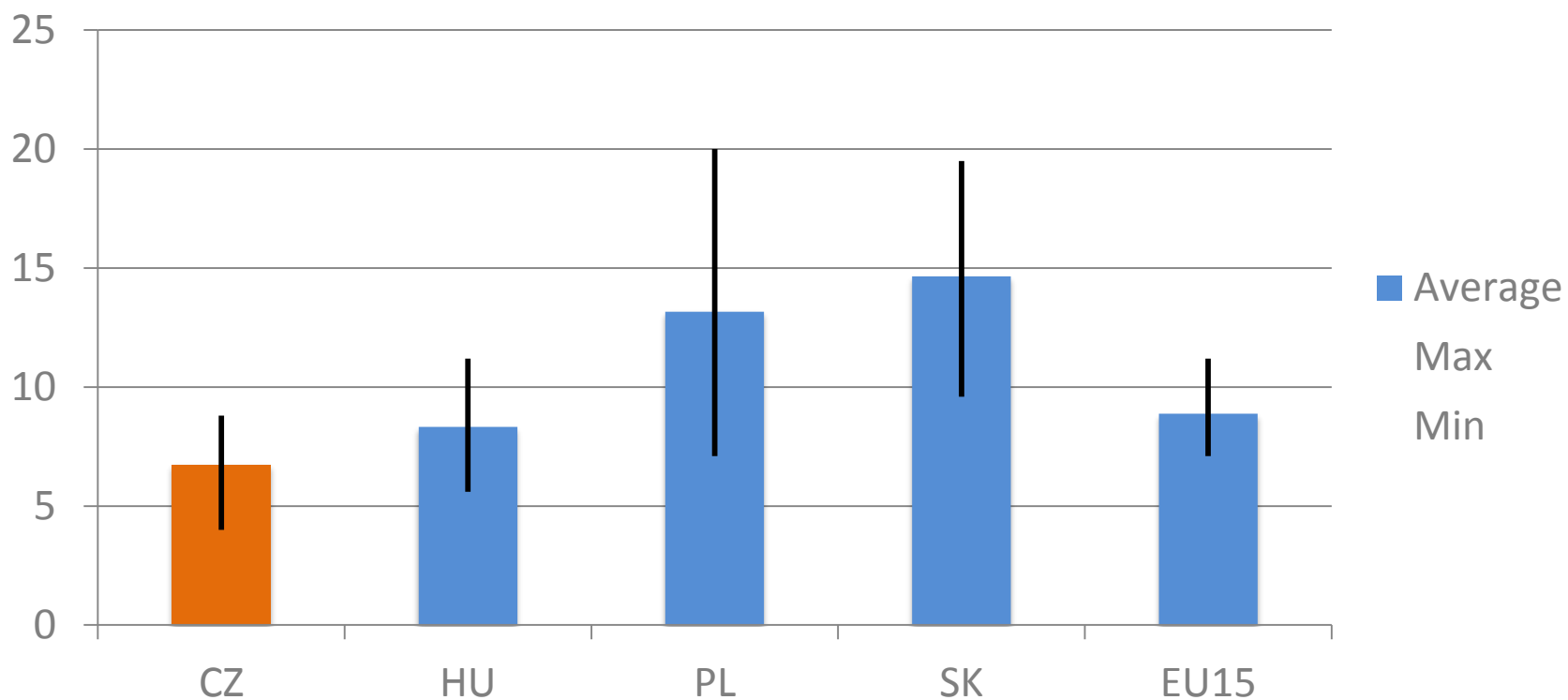
GROWTH FRIENDLY FISCAL POLICIES

- Prioritize growth-enhancing expenditures (don't cut investments)
- Shift taxes away from labour

ADDITIONAL SLIDES

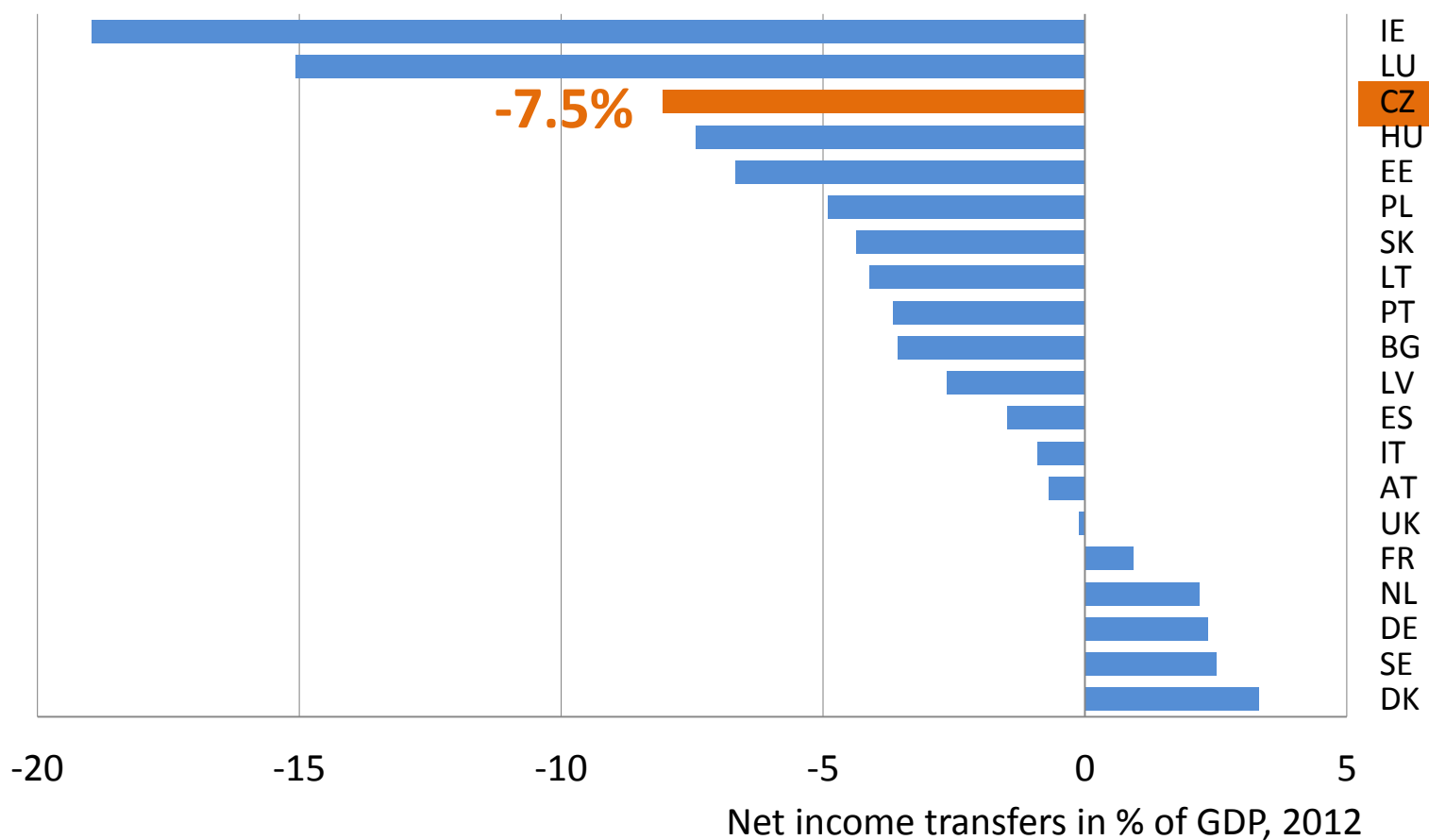
Unemployment rate remained relatively low in CZ

Unemployment rate 1995-2012 - average, min and max



Income transfers in EU-28

Share of net income transfers on GDP for CZ third highest in EU-28



Source: Eurostat

References

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CzSO (2012): Firmy se zahraniční majetkovou účastí v ekonomice ČR: oslabily nebo dále sílí?, series 1158-11.

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