

Challenges for the Competitiveness of the Czech Republic within the EU

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The research of the Centre for Economic Studies in the Czech Republic competitiveness within the European Union has identified particularly the following key challenges for a successful transition to the knowledge-based economy in the fields of macroeconomic stability, institutional quality, and innovation performance.

1. Macroeconomic performance and stability

Economic growth of the Czech Republic in the years 2000-2005 accelerated and became healthier from the point of view of the factors on the supply and demand side. Restructuring and modernization on the supply side was supported by strong inflow of foreign investments, which strengthened investment and exports. They became main drivers of growth on the demand side. EU accession eased remaining barriers in foreign trade and gave impulse to the acceleration of exports and industrial production. Real convergence to the average level of EU became sustainable. Czech Republic belongs within EU-25 to the group of mid - developed countries and is placed before new post-communist member countries (with the exception of Slovenia) and some less developed „western“ economies (Malta, Portugal). Positive change was enabled by the growth of total factor productivity, which was in this period in the international comparison exceptionally high. Rapid economic growth is not granted in the long run in the case that the Czech Republic will not implement reforms striving for removing growth barriers and will not support innovation activity, research and education, including improvement in general business conditions .

Priority of economic strategy of the Czech Republic lies in reaching robust economic growth, which will ensure rapid process of real convergence and will be based on increased labour productivity and higher utilization of free labour resources. Implementation of this strategy is demanding and needs several reforms, which will support transition to knowledge-based economy utilising qualitative growth factors. The government approved in this direction National Lisbon Programme concentrated on continued reforms of public finances, creation of environment stimulating science, research and innovations, infrastructure development and simplification of business conditions. Important challenge after EU accession is adoption of common currency, particularly the question of appropriate term for entering euro zone with adequate exchange rate, which will not endanger the competitiveness of the country on the one side and will not lead to disproportioned impoverishment on the other side. The influence of common currency on the stabilization process is to be related to the economic level of the country.

The convergence process of the Czech economy to the average level of EU will depend to a higher degree on changes in the sources of competitiveness which was based up to now on low costs (prices). An advantage of the Czech economy is a low level of unit labour costs (ULC) which amounts in nominal terms to only one third of the EU-25 average. Having

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two-thirds level of labour productivity in EU, it enables to reach less than a half of ULC in relation to GDP. Low ULC support the flow of capital from high wages countries and make effective competition of suppliers, using broader division of labour, especially that linked with German companies. The catch-up strategy needs important changes in the factors of growth. In the future a robust economic growth of the mid-developed country can't be based mainly on price (cost) competitiveness. This strategy is not perspective in the light of the potential competition coming from the very low-cost countries such as two acceding South-east European countries (Bulgaria, Rumania), other European countries outside the EU (Ukraine, Russia and other countries of CIS) and especially from aggressive competition of China and other Asian (emerging) countries. There is a main challenge for the country – higher utilization of qualitative advantages of competition linked with a broader use of possibilities of the knowledge based economy. The Czech economy was up to now insufficiently engaged in this process. The historical tradition of long-term industrial development and relatively good education of labour force were to a great extent devalued in the complicated conditions of last fifty years. The main challenge of the Czech Republic lies in a revival of this tradition and in a full engagement in an innovative process set up in the Lisbon strategy.

Economic policy supporting economic growth is to be associated with the objective of **macroeconomic stability**, which represents a condition of balanced economic development, full realization of growth potential and nominal convergence which will lead to smooth entering of the Czech Republic to euro zone. Rapid economic growth in the years 2000-2005 was accompanied in this sense by contradictory tendencies. The Czech Republic had to complement its own resources by foreign savings which resulted in high deficits on the current account of the balance of payments. High public investments in backward infrastructure together with generous social policy led to higher deficits of public finances. On the other side the Czech Republic is a country with low inflation. Contributing factors can be seen in monetary policy with lowering interest rates and appreciating currency. Risks of future development can be seen in declining savings rates of households and general government sector. Public finances can be seen as a weakest chain link of the economy. Persisting high deficits of public finances in the period of fast economic growth are dangerous and their reduction necessitates reforms of public finances based on relative reduction of expenditures. Pension reform and positive real interest rates can support savings of households. The Czech Republic experienced in last years similarly as in developed countries a strong increase of credits (first of all mortgages) provided to households. This was caused by low interest rates and by privatization of banks and their active policy vis-à-vis households. Indebtedness of households remains by international standards low. Nevertheless, there exists a risk of unbalanced development of assets and liabilities of households which can worsen the macroeconomic stability.

2. Institutional quality

Economic performance and effectiveness of innovative and education systems are negatively influenced by the extremely low level of the **institutional quality**. However, improvement of the institutional quality is a long-run process and outstanding economic performance can help this process to be perceived as successful. Nevertheless, a lot of measures can be carried out relatively fast and can bring benefits especially on the field of business environment quality. On the contrary a correction of corruption perception in the society through realization of anti-corruption programmes as well as a better evaluation of the quality of public institutions (including the effectiveness of government) are undoubtedly rather „long-distance races“.

A great challenge in the Czech Republic in case of the corruption control reflects particularly political parties' performance and the transparency of public procurement.

Under the consensus of the impact of institutional environment on the economic performance and competitiveness, primary and the most important challenge for the Czech society is essential cultivation of overall **institutional environment** as to converge to the of the most prosperous European economies level. In a long-term horizon it requires a very strong and a wide institutional change which will together result in the institutional reform. This institutional reform should include more than a remedy of the most problematic institutional characteristics as the corruption in the Czech republic (especially in the areas of public resources and in the process of political decisions making) and the quality of legal system dealing with important tasks as strengthening the independence of the courts, increasing the quality of new legislation and a better law enforcement. These problems are short-term requiring an immediate solution, although these fields will help to improvement of the institutional framework of economy as well. However, increases in the effectiveness of government and in a quality of regulation represent another necessary institutional change. The institutional reform should be done under conditions of democracy and political stability. With respect to the fact that there are different models of capitalistic system in developed European economies, while making essential institutional changes, it is advisable to focus on the imitation of the countries which are the most economically prosperous and competitive. The most successful capitalistic system in EU-15 is currently Nordic social democratic system, followed by Anglo-Saxon and central European system.

Higher transparency and better enforceability of commercial law including bankruptcy law is essential for the continuity of the Czech **corporate governance** improvement. However several challenging issues still require further attention. Cultivation of the nomination process as well as long-term composition of Boards based on real needs of the governed companies must replace widely used practice of nepotism, clientelism and political ties. This calls especially to the Supervisory Boards, where lack of financial expertise prevents the Boards from fully functioning. Higher qualification, higher compliance awareness among Board members and lower acceptance of multiple Board memberships requires revision of the quality of remuneration processes and highlights the necessity of continuous corporate governance education. Another challenge is to follow positive trends in EU markets mainly the opportunity to establish European Public Company, which can be registered in any member states in the EU, and the registration can be easily transferred to another member state, and to adopt one-tier governance system.

Improvement of **business environment** quality makes a necessary systemic condition for the decrease both of corruption behaviour and informal economy (and, consequently, for an increase of tax revenues). It also makes possible a more efficient exploitation of available private and public resources, markedly facilitates development of entrepreneurship and innovation activities, especially of small and medium-sized enterprises, and increases employment. In the Czech Republic, all the mentioned fields have been supported with a number of specific programs with considerable financial resources. Their effectiveness, however, would have undoubtedly been much higher when the business environment itself was improved. The example of the Baltics has shown that also the less developed new EU members, burdened with socialist past, are able, in a relatively short period, to reach remarkable progress in this area. In the first place, it is desirable to focus on the fields where the necessary changes can be realized rather quickly and with low cost, and, at the same time, to prepare deeper and time more demanding systemic changes including comprehensive legal reforms. The most efficient

way to the decreasing time demand and (indirect) cost of procedures related to doing business is the minimization of court participation to the cases which cannot be settled by private agreements.

3. Innovation performance

Differences in qualitative levels of **competitive advantage** and its components among the EU-25 members are very significant. The comparison also showed major lagging of the less developed EU-13 group behind the more developed members. Competitive advantage structural characteristics applicable to the Czech Republic are similar to those of other EU-13 members, although the level of development is among the highest within the group. These national differences require adequate adaptation of concepts, instruments and supporting policy measures to reflect the country-specific maturity of competitive advantage. Inappropriate focus of these instruments resulting, for example, from mechanically adopting experiences of countries at a significantly higher level of development, increases the tendency towards inefficient exploitation of resources. Furthermore, it is necessary to distinguish between the countries with less developed competitive advantage quality and adjust the necessary support according to the sources and extent of weaknesses. Where weaknesses are more of an exception and include only some points of individual components, support should be specifically targeted. On the other hand, if the overall quality of competitive advantage is very low, attention must be paid to supporting system approaches with the widest achievable impact. According to the previous comparison, the Czech Republic is currently at a transitional stage. The average qualitative level is one of the highest within the EU-13, i.e. the fundamental conditions for its development have been created. However, there is a lack of sufficiently effective (system and at the same time strong) impulse for significant advancement.

The performance growth of **national innovation system** has been conditioned both by the growth of its elements and, in particular, their restructuring. The comparison with the situation in the EU has indicated that the relative size of the key element of innovation performance – research and development – is located under the average level of EU-25 but at the first position among the new EU member countries. This position has been also confirmed by data about the relative size of published scientific articles. The research and development in the enterprises is now also well situated. It is not only because of their traditionally strong position in the national research and development system but also its funding growth and dynamics of research in the technology advanced branches of manufacturing and services. The unfavourable position of research at higher education sector has also got improved. A more radical changes in this sector have been constrained – besides its internal issues – by slow-down in public funding of research and development, upon which the higher education sector is still dependent. Negligible share of enterprise resources in funding research at higher education is also one of reasons of its weak position in the national innovation system.

Comparatively favourable situation can be identified in the **innovation performance** of enterprises. The share of innovating enterprises is still under the average level of EU-25 but at the front position in the group of the new EU member countries. The innovation capacities of the enterprises have been mobilised in particular by influence of market factors (demand for innovation and growth in the implementation of product innovations). The weaknesses of innovating firms have been emerging in their insufficient links to knowledge producing organisations (research organisations, faculties of higher education, consulting firms, patent servicing). A low interest of banking sector in financial support of innovation projects can be also mentioned as another source of their weakness. The evaluation of this issue is suggesting that the pattern of the domestic infrastructure for support of innovation has turned out to be pro-

ductive in adaptation of innovating firms to available innovation resources (mostly in the form of capital and technology transfers from abroad) but weak in their creative modification to a more advanced technological application and market implementation. A transition from the adaptation pattern to the modification one (the latter one being more suitable for small and technology advanced countries) can be - in the case of the Czech Republic – supported by some available resources: level of education of population, size and level of new scientific personnel in natural sciences and engineering, dynamics of research and development in the technology-advanced manufacturing and services. So far, the mobilisation of such resources has been constrained by a closure of academic institutions in relation to challenges of innovation in industries and by the implementation of ineffective regulatory means of innovation policy.

The nature of **information society** in the Czech Republic is developing fast in the context of steady stronger potential of information technology (IT). Individuals and mainly households are IT equipped less than other countries (only mobile devices are exception). The technological infrastructure in the commercial sphere and in public and state administration strengthens on the other side. The frequent problem is a disharmony of installed and used technologies and applications on the one hand and the quality of business processes and their optimization within an organization and also between an organization and its business partners or citizens on the other. The information services as a special kind of goods, resp. added value to a primary product are becoming a part of business activities in the Czech firms and state institutions. Nevertheless the trade, incl. the foreign trade with information products and services is less significant in the Czech Republic in comparison with abroad. The limited factors in companies are the level of user preparation using new information technologies, functionalities and integration of ICT applications. One of the frequent problem of effectiveness of ICT usage is the quality of IT management where there is often no process oriented approach, no metrics suitable for ICT maintenance and development and no learning and application of standards. The special character of informatics in the Czech Republic is in the area of small and middle sized companies. While the ICT equipment of these companies is on high level, the software applications are concentrated on support of regular operation based on standard transaction systems. On the other hand the usage of analytical applications, applications for effective customer relationship or other special applications with added value is limited in this category of companies.