CZEXIT: HOW TO WILLINGLY AMPUTATE BOTH FEET.

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The idea of Czech exit from the European union resurfaced after the 2017 elections.

Unlike for UK, for Czech republic, the exit would be an economic disaster,…

…with exchange rate plummeting amid widespread capital flight, strong rise in inflation and loss of money from EU, to name just a few impacts.

We would then end up with the worse deal than before.

Czech Republic held the **parliamentary elections full four months ago** and yet **doesn't have the legitimate government in place**. What it does have is, actually, the least legitimate of all governments Czech Republic has had in its modern, post-communist history. Led by Andres Babis, a billionaire whose wealth is of very dubious (1990 dubious) origin, got just 78 votes in the January vote of confidence. This is not only far below 101 needed but also 2nd lowest number in the 18 votes of confidence Czech Republic has had since 1992. The only reason why the government still exists is old-new President Zeman's tacit pact with Andrej Babis whereby former gave the latter another attempt to try to form the government, even though the latter failed spectacularly in its first one.[1] As per Constitution, the outgoing government governs until the new one is formed…

Economic observer oblivious of politics could be forgiven for failing to notice, though: **the economy doesn't seem to care**. CZK is stronger than what it was after the elections, economy is growing strongly and inflation decelerated from last year's levels of close to 3% to under 2% in February, raising the real wage growth. The winner of the elections – ANO of Slovak billionaire Andrej Babis – has spent four months since elections figuring out who it is that the 'movement for everyone', as ANO labels itself, is closest to, talking to, and finding 'large program overlap' with, in turn, everyone from extreme left (Communists) to extreme right (Freedom and Direct Democracy, or SPD), only to end up with no working government at all. I know it is hard to figure out who you are closest to if you don't have any value-based program to speak of, but…

Since there is no government, it is certainly premature to talk about the possible economic policies of the government. Not that there weren't any mentions from ANO of what it'd do if it had a coalition in Parliament, just the contrary: ANO is pregnant with ideas. Mostly, however, of quality as if cut out from compendium of economic populism. They would for example "*want to try* (!) *pension reform*", they propose to lower VAT on as systemically important things as beer, flowers, bike and shoe repairs and windows washing (kid you not). Trains are to be for free for students and pensioners (copy from ex Slovak PM Robert Fico). Taxes for self-employed and employees are to fall, a commendable idea except for the fact that timing is dismal: why to do fiscal expansion at the height of a cycle? "*Highways, bypasses, stadiums, concert halls*" are to be built, but nobody seems to say how it will be paid for or whether projects are at least remotely ready (recall that previous government, of which ANO was key part, had a hard time utilizing the EU money for infrastructure projects of higher importance because of dearth of projects).

That said, **'economic policy' that caught the media attention most was the idea of exit of the Czech Republic from the Eurozone**. This is idée fixe (and, with fear of Muslims, raison d'être) of SPD, but is also advocated by segment of the notoriously anti-EU Civil Democrats (known by Czech abbreviation ODS), esp. its part around the son of the former President, Mr. Klaus Jr., and, very recently (last

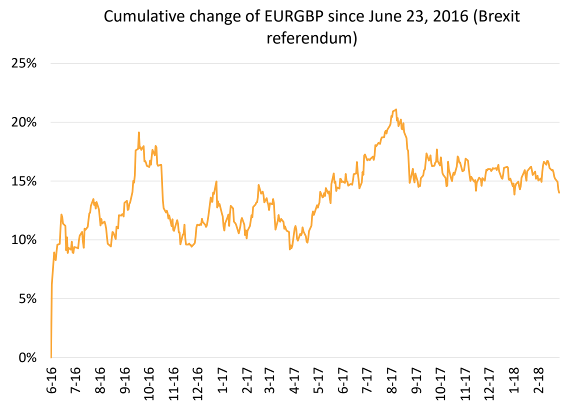
[1] As per Constitution, the outgoing government (of PM Babis) governs until the new one is formed.

week), also by some Social Democrats ↗ . The fact that this 'idea' cuts across party lines makes it the most dangerous economic policy "proposal" of all.

The populist / extremist SPD of Tomio Okamura, the most vociferous proponent of the Czexit campaign, claimed recently that "*nothing would change economically after the exit*", that they don't "*know what the problem is*" because "*everything will work as before, only without the diktat of Brussels*". Let us see why this thinking is that of the three-year old thinking that one can have a cake and eat it.

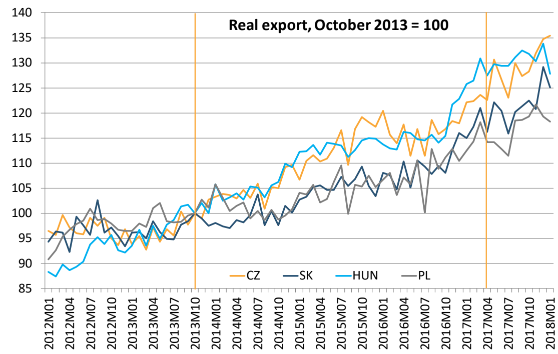
In what follows, I shall give examples of few things that would certainly change and that wouldn't work as before. Not even by a long shot. I shall stick to economy, admitting fully that there would obviously be many other impacts in other areas. And all of the effects would depend on what kind of deal we'd get after the exit – and let us make it clear, there wouldn't be much of choice (see below).

The first immediate effect of the decision to leave – or, in Czech instance – of already the decision to call the referendum on the continuing membership in the Union, would be **massive weakening of the CZK**. This is what happened with the pound after the UK referendum in 2016 and it is impossible that it wouldn't happen with CZK. Moreover, in Czech case, the vulnerability of the currency (sensitivity to any such shock) would very likely be significantly higher than in the case of UK. As explained in greater detail below, our links to European Union are much stronger than are those of UK while our weight in the European union is order of magnitude lower than that of UK, making any post-Czexit discussions essentially a Brussels' monologue. Or, in Okamura's words, diktat.



SOURCE: 42 FINANCIAL SERVICES

Now, of course, weakening of CZK is a double-edged thing, a powerful redistributive event. **On the one hand, massively weaker CZK would be boost to exports**, akin to the interventions of CNB over November 2013 – April 2017 period, only on a much greater scale. As the evolution of the real exports over that period (delimited by the yellow lines in the following picture) indicate, 'normal' weakening of the currency (<10%) doesn't provide large boost: over the entire period of CNB interventions, cumulative growth of Czech exports was merely approx. 6 pp. higher than in Slovakia, and was lower than in Hungary.



SOURCE: EUROSTAT ↗

In Czexit, though, weakening would be massive and much, much larger than during interventions. See, GBP weakened by 19% against the euro in 4 months following the referendum and is still about 14% weaker against the common currency almost two years on. In the run-up to the referendum and/or after its negative outcome, CZK would easily weaken by 25% or more (i.e., to well over 30

CZK/euro). The boost to industry would thus be larger than during 7% weakening that followed November 2013 CNB's entry into the market.

On the other hand, the openness of the economy guarantees that such a massive weakening would be reflected in domestic inflation. Again, there wasn't much to be seen in prices (despite what CNB claims) after the CNB intervention, but that isn't a good comparison to what 25%+ weakening of the currency would cause. The **inflation** would surely – especially in situation like the current one when economy is growing at / above its potential – **accelerate rapidly to well north of 5%** and close to 10%.

Strong capital flight from the Czech Republic would ensue, impacting first the government bonds. This would be so if the referendum were to be held in next few years: over a third of all the bonds is still held by non-residents (courtesy of CNB's 1277-days-long anti-CZK campaign) which raises the sensitivity of Czech yields. The rise of the government bond yields would be large and would naturally propagate throughout the markets, impacting all the interest rates in the economy. Hence, I don't expect CNB would have to tighten much due to weak CZK: the markets would tighten the conditions by themselves. Here, UK's bond market response to the Brexit referendum (10Y *fell* from 1.4% before the referendum to 0.5% in few weeks thereafter) is not a good example as that is a self-standing economy with very strong asset markets (financial, real estate) whereas Czech Republic is economically only a constituent state of Germany, and with no asset markets of any importance to speak of. A flight to government safety of UK sort would be unlikely in economy so dependent on EU trade as Czech one and so foolish as to have cut itself off from it.

Obviously, if referendum were held when all of the government debt was held by Czech banks, as had been the case before the interventions, the conclusion would be different. **But irrespective of what would happen with the bonds, general capital flight would ensue.** Real estate prices would fall, especially in Prague which would no longer be seen as center of CEE from which to do business in the region. There is *stock* of about CZK 3100 bn. of foreign direct investments in the Czech economy (around 62% of 2017 nominal GDP), with 82% having come from Eurozone (23% Netherlands, 14% Germany) and 89% from the European Union. The FDI *inflow* was about CZK 240 bn. in 2016 and CZK 173 bn. in 2017, again predominantly from European Union.
FDI money would certainly stop coming in immediately, pending resolution of our future status, and money that is already here would start to look for ways out, especially with three EU member economies in the neighborhood of Czech Republic. Of course, a lot would depend on what kind of regime would markets assume would take place after the exit but I don't presume markets would want to take chance here.

That is because, after the exit, no leniency or good-will from EU should be expected. The negotiations held between EU and UK since Brexit referendum show that with brutal clarity. Last week, 129-page draft agreement[2] on the withdrawal of the UK from the EU was published ↗ and even the casual reading of it shows that the UK will be leaving European Union on almost exclusively European Union terms. UK yielded to pretty much all the conditions of EU (except illusory[3] right to sign its own trade deals while still in EU and kick-the-can-down-the-road deal it won on Northern Ireland border[4]) and the only thing it got in exchange was longer transition period in order to avoid hard Brexit next March which was looming large.

And make no mistake: trade deal with Britain will not be anything extraordinary, even when it comes. There is no continuum between Norway style deal (=economically the same as staying in EU except for no say in how EU is run) and Canada-

[2] This agreement stipulates that there will be 21-month transition period when UK will remain the member of EU but with no say in many of its affairs.

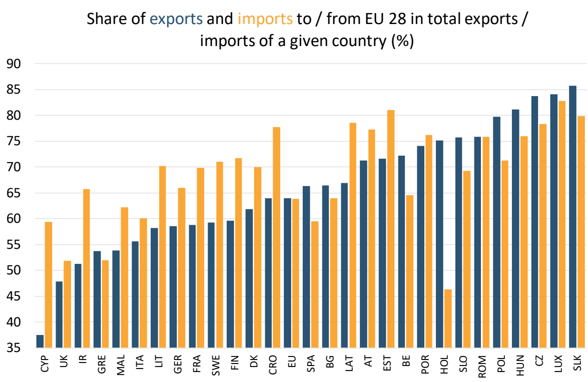
[3] Illusory because who'd want to sign a deal with UK without knowing how UK will trade with EU?

[4] EU acceded to UK demand that the Irish border issue isn't decided now as a precondition for moving further, but that it shall be part of future trade talks. This means nothing as it only moves the problem to the future: EU/ Ireland want no hard border between Northern Ireland and Ireland (The Troubles is what's on everyone's mind here), and certainly don't want to invest in any, which means N.Ireland must stay inside the EU for all practical purposes (i.e., in customs union). This is unacceptable to Therese May government or its allies in DUP.

style deal (with zero tariffs but restrictions in trade of services and of course with hard border checks). As EU showed clearly many times before, it will not budge here & it is capable of playing hard. Essentially, UK will be given take-it-or-leave-it offer at some point in the future and that offer will be on EU terms.

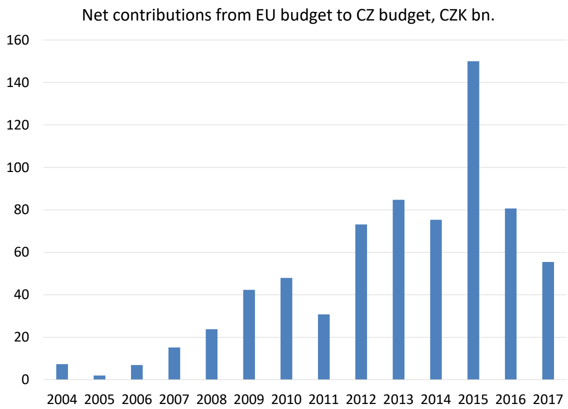
Now, with EU not exactly dealing in gloves with UK, **imagine how would EU approach a troublemaking nation of 10.6 mn. people** (2% of EU) **that accounts for 1% of EU GDP**, with which there is very **little need or wish to cooperate in security questions**, that doesn't have nuclear weapons and **that's done very little during its short membership in EU except for extending the hand for the subsidy handouts**.

Let me make this clear: EU would ride roughshod over us as, with another exit after Brexit, EU would be fighting for its survival. Essentially, we'd be told to go Norway way (i.e., join EFTA and EEA[5]) or nothing else (=WTA rules). Who'd want to lose time negotiating 500+ page long FTA with somebody as "important" as us? Remember that our **share of exports to European Union is third largest among all EU28 member states whereas the export to CZ is negligible from the perspective of the European Union.** So not only would it be existential for us not to have to rely on WTA rules (while European Union couldn't care less…), but our dependency on EU trade would further weaken already extremely weak negotiating position.



Source: Eurostat

Norway-style deal[6], i.e. accepting almost all acquis that comes with EU membership (incl. detested Dublin regulation governing asylum seekers, which all EFTA members subscribe to) **without having a say in its affairs, would also mean no more money from EU.** Czech Republic has received net EUR 26.3 bn. (CZK 695.5 bn.) over 2004-2017 period from the EU budget and stands to receive billions of euros more in the coming years. With Czexit, this would evaporate.



Source: Ministry of Finance

Not only that. EU would very likely require us to start paying for the privilege of having access to single market, just like it does of Norway. For illustration, Norway contributes about EUR 400 mn. annually to cohesion efforts, EUR 450 mn. annually to other selected programs etc. (it gets something back, though it doesn't seem to be a lot). For us, we'd likely get essentially nothing back and would be at the mercy of European Union: we'd have to pay pretty much what it'd tell us to (though it might condescend to not ask as much as from Norway in light of our lower economic level). But we certainly would go from net recipient to net donor.

Now, all of these are economic impacts. As mentioned above, these would by no chance be the only impacts, but ones which would be felt

[5] Presuming Liechtenstein, Switzerland, Norway and Iceland would let us in.

[6] In such a deal, we wouldn't be bound by common agricultural policy (= would lose subsidies), justice, we wouldn't have to play by tax harmonization rules (which we'd do anyway – we can't afford being a tax haven) and we wouldn't be part of customs union (=could set our own tariffs, an unimportant source of revenues).

most immediately. There would be many others, with long queues at the border when coming from abroad just one illustration…

Let me say this at the end. Although I understand that *politics is war without bloodshed (and that war is politics with one*[7]), if there is one thing that should've come out of Brexit it is that domestic politicians ought not to try to solve the domestic political problems with EU referendum - Cameron could talk.

How likely it is that Babis commits the same mistake like Cameron in order to entice an anti-EU party into the coalition? Well, this is hard to say – but with Babis' business interests heavily grounded in the European Union it should at least make him think three times before choosing to go down the Cameron-like road. Should.

[7] Mao Tse-tung, "On Protracted War" (May 1938), " Selected Works of Mao Tse-tung, Vol. II, pp. 113–194.

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