

EU Sanctions against Russia and Their Impact on the Czech Machine Industry

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Abstract – The Czech machine industry is one of the most important industries significantly affecting the overall development of its GDP. Despite the unfavourable situation in 2008 – 2013 when industrial companies were adversely affected by economic recession, the worst threat for companies are sanctions imposed against the Russian Federation. Many Czech machine construction companies operating in Russia are now afraid of termination of contracts, non-payment of invoices, depreciation of investments due to the falling value of the rouble etc. Moreover, should this downward trend persist, we can anticipate serious problems with payments and agreement on payment terms with Russian banks which would mean significant limitation of investments to imports, facilities and technologies. The results of an empiric research further indicate that Czech machine construction companies exporting to Russia have to find new outlets for up to one fifth of their production because of the sanctions imposed. However, currently it is certainly not a simple matter finding new “alternative” markets. The sanctions cause significant problems with the sale of finished products. Thus, there is the concern that the “sanction” policy could finally have catastrophic consequences from the point of view: a) suspension of cooperation; b) loss of a market that will be filled by competitors from other countries.

Keywords – companies; sanctions; machine construction; Czech Republic

I. INTRODUCTION

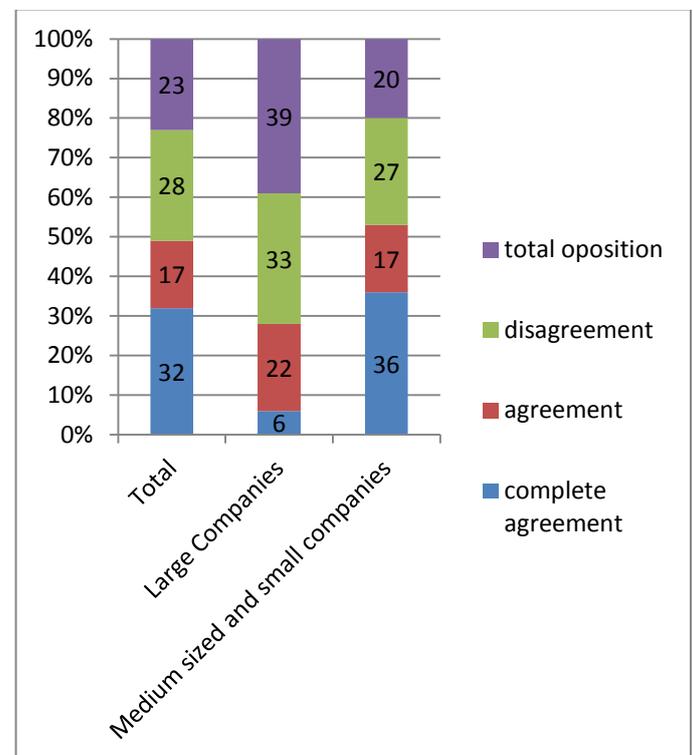
The results of a study of Czech machine construction of January 2015 completed by CEEC Research (2015) based on data collected by means of 100 personal and phone interviews with managing directors and board members of chosen small, medium-sized and large companies in November 2014 – 2015 indicate that all machine construction companies across the Czech Republic are afraid of the sanctions imposed by the European Union against Russia.

Moreover, the research indicated that sales of machine construction companies exporting to Russia would drop in the short-term period (2015) and long-term period (2016-2017) on average by 18 – 19 %. According to the estimates of their managers, major companies could lose 20 % of their sales this year and even more than one quarter (27 %) of their sales [1].

Respondent machine construction companies do not have the same opinion concerning the correctness of the sanctions: one half of them (49 %) agree with them and the other half (51 %) is against them. Significant disagreement is apparent in the large machine construction company segment where up to 72

% of companies do not agree with sanctions. According to company managers, Czech production could be replaced mainly by products from Asia (this is anticipated by up to 56 % of machine construction companies) because there is huge competition on the machine tool market and Asian companies above all are ready to fill the potentially abandoned positions immediately.

TABLE I. WHAT IS THE ATTITUDE OF COMPANIES TO SANCTIONS AGAINST RUSSIA ?



Source: CEEC Research [1]

The Czech Republic at least partly succeeded to mitigate the impacts of sanctions on the Czech economy when its objection to EU sanction measures against Russian Federation was accepted in August 2014. Thus, the sanctions do not include at least machine tool exports. As the Czech Prime Minister, Bohuslav Sobotka, says, we have succeeded in protecting as much as possible Czech machine construction exports that could be endangered if the Czech Republic had accepted the original proposal prepared by the European Commission.

The above mentioned proposal to extend the sanctions covered financial markets, delivery of military material, dual use goods and special oil mining technologies designated for Arctic regions and technologies that can be used both in the civilian and military industry. It was recommended to individual member countries to think about imposing new sanctions concerning the participation of the Russian Federation in some sport events and limited access of Russian government controlled companies to European loans.

The Czech government established a working group for this purpose. It was charged with analysing impacts of individual sanctions against the Russian Federation in the direct context of (not only) Czech machine construction companies [2].

The Russian Federation Government Decree of 14 July, 2014 banning the purchase of certain types of machine construction products for government or public purposes or for an instant ban to import precision machine tools with a certain number of controlled axes will affect approximately 2 – 5 % of the Czech machine construction industry, as a study prepared by the Czech Ministry of Foreign Affairs claims. Now, we can also see more restrictions concerning required delivery criteria. Czech machine construction companies are forced to apply for a licence for each individual case and present information on the customer. These requirements were in place already in the past, however, now they are much stricter [3].

Czech exports to Russia were constant in the first half of 2014 if compared to 2013 in CZK (measured in EURO, they saw a 5.6 % decline). There is no doubt that decline of exports to countries exporting to Russia will adversely affect Czech business. This includes Germany with the total decline of 16 %. Moreover, we have to take into account the falling Russian economy [4] [5].

If we compare total Czech export figures to the Russian Federation against the EU, we have to conclude that this number is not very significant. As to Russia, the figure is just 4 % and in case of EU, it is 80 %. However, what needs to be stressed is the fact that it has been apparent since 2008 that the dependency on the European territory is problematic in the long-term perspective as this market is seeing economic stagnation. It means that each company has to diversify their export portfolio in a way so it is flexible, attractive and competitive. It is equally important to state that any change of orientation to other markets is not a question of a year. What plays an important role in this process is the description of the market, its orientation, getting established in the market, language barriers, customs, trust etc. That means that Russia and the ex-Soviet space where Czech companies have got established are option number 1 for Czech exports that should be perceived first of all from the pragmatic point of view.

Furthermore, we should mention that the factor that adversely affects Czech companies in the Russian Federation more than the ban on supplies to Russian defence industry companies is the lack of funding on the part of their Russian customers, their fears of future development and their unwillingness to invest. The greatest worry is the loss of laboriously achieved positions in the Russian market.

According to empiric research, company managers claimed that more than a third (35 %) of Czech machine product manufacturers would try to find customers in other countries. Almost two thirds (68 %) of large companies will do so as they need to find new outlets for a part of their production in order to sell what they planned to export to Russia.

One of the reasons may be the policies of Vladimir Putin as it is generally known that Russia is currently focusing more on the development of its political, business and personal relations with representatives of the People's Republic of China, India, Turkey and other economically attractive companies. Companies from these countries are ready to supply premium goods and technologies to Russia with the support of their governments without the need to pay in USD or EU. This is of key importance for Russia and European companies may very quickly lose the positions and relations they built up over a long period due to this turn of events.

Information provided by representatives of machine construction companies indicate that they are fully aware of this situation and they have already started to focus on European clientele (including but not limited to France, Germany, Poland etc.) and other markets worldwide (Asia, China, Latin America, Africa etc.).

II. INDUSTRY IN THE CZECH REPUBLIC 2008 – 2014

Czech industry employs more than 40 % of all economically active population. Core Czech industries include the chemical industry, machine construction industry, food processing industry and metallurgy. Other important industries are energy, building industry and consumption product industry. The defence industry and glass industry rank among those less important industries. In the Czech Republic, industry is one of the key segments of the national economy (approx. 35 %) and it generates a significant portion of the national product [6] [7].

In 2008, statistic figures concerning industry included 1 462 000 employees, 9 063 entrepreneurial entities employing 20 and more workers and 145 977 entities with less than 20 employees. Employees' total wages amounted to CZK 352.483 billion. In Q4 2009, industry generated 97.7 % of industrial production as against Q4 2008. The most important was the production of motor vehicles (119.7 %, again compared to Q4 2008), followed by the production of chemicals (115.9 %). The last position was occupied by the clothing production (74.7 %) and machine manufacture (77.5 %) [7].

In January 2010, industrial production experienced a 5.3 % year-to-year growth, the number of employees in companies with more than 50 employees dropped by 13.1 % and industrial activity revenues grew by 0.3 %. Industrial goods are an important part of exported and imported goods. As for industrial goods, machines and transportation means (54.3 %) followed by various market products (17.4 %) and industrial consumable items (11.1 %) contributed to exports in January 2010. As for imports, the most imported items were machines and transport means (42.4 %) followed by various market products (18.1 %), chemicals (10.7 %) and industrial consumable items (10.6 %). To compare, a country with the

highest share of exports and imports is Germany with 25 % (imports) and 32.9 % (exports) [7].

Industrial production saw a 0.8 % decline in 2012. This trend continued in 2013 with further decline (5.4 %) in Q1. In Q2, the decline rate decelerated to -2.4 %. The total industrial production for the first half of 2013 saw a 3.9 % year-to-year decline. The weakening of the economy and a decline in industrial growth in the Eurozone countries and Germany resulted in a drop of Czech economic performance. The 2013 results in Germany and Eurozone were influenced by advance indices values (indicating growth of production and improvement of their business climate and growing business confidence). This positive news was reflected in the recovery of company contracts [8].

Behind the unfavourable trend of the Czech Republic's industry were the deepening problems of industry provoked by weak foreign demand and a fall in domestic demand. Problems the European automotive industry market faced due to falling demand affected key Czech industry companies and caused deceleration of production activities.

In Q1 2013, the production of the processing industry went up in eight segments, for instance in other processing industry (4 %), production of basic pharmaceutical products (3.5 %), wood processing industry and production of wooden products (3.2 %) and clothing production (1.6 %) [8].

As far as more important industries are concerned, slight improvement was experienced in the field of production of the machine construction industry (0.3 %). The growing industries contributed to the overall performance of the industry with 17.8 % (except for machine construction, this refers to less important processing industries). Production declined in fourteen industries, the most significant decline was reported by computer manufacturers (15.6 %). This fact largely affected the HIGH-TECH sector where the industry has a significant position. The critical industry - manufacture of motor vehicles - saw a decline of its production by 6.7 % in 2013 and its share in total industrial production was 25.3 %. What caused this unfavourable development were problems of the European automotive industry that resulted in a decline of sales of cars in the EU and in Germany (the biggest European car market). This resulted in a decline of the production of Czech car manufacturers and then in their supplier industries and segments [8].

The lower performance of Czech industry in Q1 2013 (with the production broken down to core industry segments) resulted in a decline in all segments. Production was lower in the segment of the production of long-term and short-term goods (both minus 1.6 %), semi-product production (minus 2.1 %), production for investments (minus 5.1 %) and energy generation (minus 6.6 %) [8].

The further trend of industrial production is illustrated by volumes of overall contracts in chosen industries. In Q1 2013, total contract volume dropped by 3.6 %. Of it core foreign contracts (their share in the total volume of contracts was 70.3 %) saw a 3.4 % decline. There was a 3.9% decline in domestic contracts and their trend was affected (thanks to strong mutual economic links) by the trend of contracts in the Eurozone

countries and, first of all, in Germany as the most important Czech trading partner (with approx. 30 % of all Czech exports). The following months saw a recovery of export contracts and growing volumes of domestic contracts and this fact had a positive effect with growth of industrial production. Industrial sales declined (2.9 %) and the lower total employment rate (1.4%) resulted in Q1 2013 in a fall of labour productivity (1.5 %) (the real wage fell by 2.4 %). This trend led to stagnation of nominal and real unit wage costs in this period (0.9 %) [8].

In Q1 2014, Czech economic production saw a 0.4 % quarter-to-quarter growth and even 2.5 % year-to-year growth. It was the most dynamic rate for the last three years [9].

The year-to-year GNP growth was achieved with the contribution of all core items and a decisive role was played by recovered investment activities characterised by 5.2 % fixed capital growth. Final consumption stabilised with roughly equal dynamics of 1.44 % in the household and government sector. Export output reported almost a two-digit growth [9].

The number of employed people experienced a 0.8 % year-to-year growth and also the general trend in the unemployment rate was favourable. It dropped to 6.9 % (year-to-year drop 0.7 %). Inflation significantly lost its momentum and its average rate in March was 1 %. The reason was a sharp drop of regulated prices and, to a lesser extent, the gradual disappearance of primary impact of the change in the VTA rate as implemented the previous year¹.

The industrial production accelerated to 6.7 %. The highest growth was experienced in the production of motor vehicles, trailers and semi-trailers (19.9 %) and production of computers and electrical and optical systems (17.8 %). Export oriented production was behind the total 17 % year-to-year export growth and year-to-year trade balance surplus by CZK 30 billion¹.

III. GOVERNMENT SUPPORT

Table No. 2 indicates the way most machine construction companies assess government support in the context of sanctions against the Russian Federation. This evaluation took the form of scoring (1 – 10 points scale, 10 is the best score.)

The president of the Czech Republic, Mr. Miloš Zeman, can be seen as a key person in the context of sanctions imposed against Russia, Czech machine construction companies most appreciated support to those looking to find new outlets (6.4 %), in terms of finding new markets such as China, Kazakhstan, UAE etc.

Other significant support named by company managers was possible simplified access to funding and insurance for export operations by the Czech Export Bank and Export Guarantee and Insurance Company. Although the Czech Export Bank suspended funding of individual projects in December 2014, nevertheless, it decided to resume all credit for Czech export

¹ In 2013, the Czech Republic increased at the lower VAT rate from 14% to 15 % and also an increase in the basic VAT rate from 20 % to 21 % . This had resulted in an increase in unit prices and load the economies of individual enterprises.

operations to Russia. According to the press spokesman Mr. Křížan, the CEB will prefer transactions in the territory of the Russian Federation where the loan maturity is up to seven years and it will support credit granting in the form of club loans and syndicates with the involvement of strong Russian banks as creditors. Currently, the volume of loans provided by the CEB is approx. EUR 1.071 billion, that means one third of all client loans. It is ready to provide loans covering operations taking place in Russia worth EUR 357 million in compliance with the bank's internal limits [10].

TABLE II. GOVERNMENT SUPPORT IN THE CONTEXT OF SANCTIONS IMPOSED AGAINST THE RUSSIAN FEDERATION

| <i>% companies</i> | <i>Reviews (0-10 max)</i> |
|--|---------------------------|
| Support to companies finding new outlets (58%) | 6,4 % |
| Funding access simplification (61%) | 6,3 % |
| Kurzarbeit (64%) | 6,0 % |
| Financial compensation (47%) | 5,8 % |
| Increasing insurance limits (54%) | 5,8 % |

Source: CEEC Research [1]

The managers mentioned kurzarbeit (short-time work) as another significant type of support. It is a duly operable system implemented in Germany from where it was adopted in 2014. The support has the form of a contribution paid to employers to keep their employees although the companies do not have work for their employees due to economic recession or sanctions against Russia and they would have to dismiss them. In the Czech Republic, companies are paid 20 % of the average Czech salary through employment offices from funds designated to active employment support. Applications for this contribution are assessed by the government and it can be paid for half a year, in an exceptional case for a maximum of one year [11].

In general, most companies see the government support of export operations as insufficient (87 %): Somewhat more optimistic are large companies. 27 % of them see the current support as sufficient unlike medium-sized and small machine construction companies: 11 % of them see the government support to the acquisition of new outlets as sufficient .

From the point of view of possible Russian counter-measures, Czech manufacturers are most afraid of the ban on export of their products to Russia and associated loss of long-term established position in the Russian market. They are also afraid of the possibility that the payment discipline of the Russian customer will deteriorate (for instance due to the falling value of the rouble) and, last but not least, of potential problems with oil, natural gas and other mineral raw material supplies that can affect the stability of the Czech energy sector and supply of sufficient resources and materials for their products.

IV. RECOMMENDATIONS AND PROPOSALS

Although the Russian Federation is not the most important outlet for Czech machine construction companies, sanctions are

perceived as a danger for further development of business opportunities. What could be seen as a principal trading policy measure is the lifting of sanctions. However, the lifting of sanctions is not realistic because political concerns decide. This is why the recommendations have to respect this fact and they have to be implemented on another level.

Certain measures can be implemented in the framework of economic policies of the Czech Republic. We can imagine more incentives stimulating demand in the Czech market, improving activities of agencies that are supposed to support Czech industry (Czech Invest; Czech Trade) and higher government guarantees supporting pro-export policies in the framework of international trade. As we all know, practical implementation of scientific and research findings in the Czech Republic is considerably inefficient. Government agencies should find tools to strengthen the knowledge economy (i.e. an economy based on knowledge) [12]. Thus, the development of an educational system taking into account practical needs should be a principal and priority task.

An important condition stressed by machine construction companies is the stability of the legislative environment as it would facilitate adaptation to such changes as dynamic changes of external business conditions.

The Foreign Ministry should focus more on economic interests of Czech economic entities and it should help to support such interest in foreign markets. Embassies should be more involved in the search of business opportunities and creation of business contacts. In other words, embassies should economise their activities more.

V. CONCLUSION

Sanctions imposed on the Russian Federation by the European Union damage the business interests of Czech machine construction companies. The problem is not just the falling trade volumes but in particular disruption of business contacts, growing business partners' distrust and creation room for competing companies. The Czech economy in 2008 – 2013 experienced a deep economic decline with moderate recovery periods. This is why each lost business opportunity can have serious consequences for the Czech economy. Machine construction companies' losses in the Russian market cannot be just seen as the losses of such companies but also a loss suffered by the entire Czech economy. Problems introduced by the sanctions and the way companies are dealing with them are described by the research based on 100 Czech machine construction companies. Finally, we must conclude that both individual companies and the government have to implement individual measures.

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