# Economic and Political Relations between Germany and Visegrád Countries in Turbulent Times

**Beáta Farkas**[1]
**University of Szeged, Hungary**

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WORK IN PROGRESS

**Abstract**

The capitalist transformation in the CEE countries has resulted in a capitalism model on the one hand which has distinctive features from other types of capitalism in the EU but on the other hand it is a completed market economy which is able to reproduce itself. In the CEE institutional arrangement modernization is based on FDI. The CEE countries achieved substantial economic convergence to the western EU member states even if their institutional model has limited convergence capacity in the long run.
In the economic success of Visegrád countries their integration into the German industrial export production, supply chain has been decisive role undoubtedly. In the EU debates these countries are regular supporters of German economic policy, e.g. in the issue of rigorous fiscal policy. This study investigates whether the recent challenges undermine the politico-economic status quo in Central Europe. The migrant crisis reveals that despite twenty year economic integration, close cooperation there are very different attitudes in Germany and Visegrád countries concerning political, social values. The problems, which emerged seem to be persistent thus lasting political tension could impair economic relations. Weakening cooperation could be harmful for both Germany and Visegrád countries. Therefore it is worth scrutinizing the different levels of economic and political relations and their interactions in the current turbulent period.

Keywords: Germany, Visegrád countries, economic relations, Central and Eastern European capitalism model, migration pressure

The assessment of economic transition in the Central and Eastern European (CEE) post-communist EU member states is different in literature[2] however there is a common point which is generally accepted. There is an agreement that foreign direct investment (FDI) plays a unique role in the modernization of the economies of this region. The most successful example of this development model is the German-Central European supply chain which was accompanied by harmonious political relations between Germany and Visegrád countries. The migration crisis in Europe has broken these idyllic relations since 2015. Germany and Visegrád countries have followed completely different migration policy which has caused

[1] bfarkas@eco.u-szeged.hu
[2] See the literature review: Farkas 2016

severe political tensions between them. In this paper I overview the economic relations between Germany and Visegrád countries and the significance of these relations in their economies. Based on this investigation I assess possible impacts of the tension between economic and political spheres in the region.

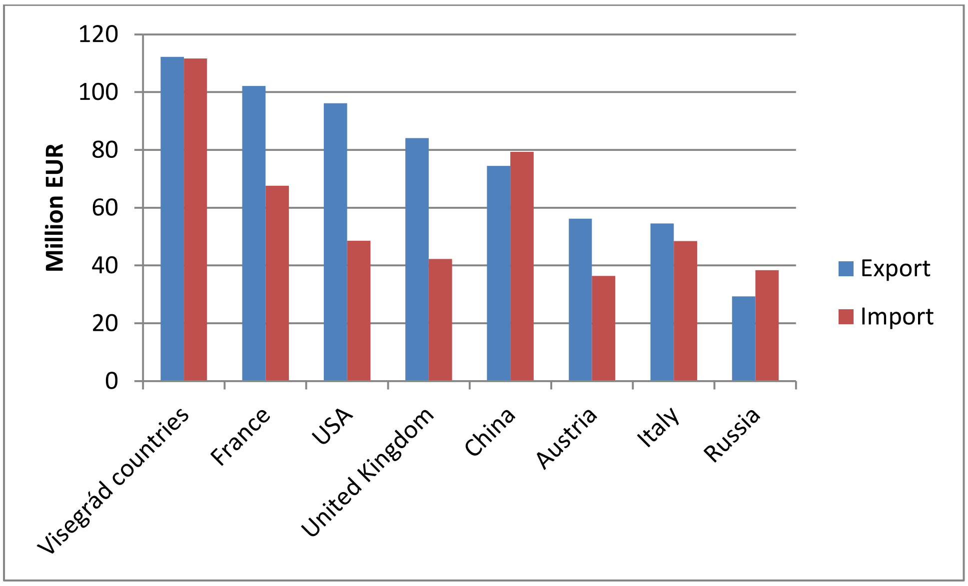
*Trade relations*

After the difficult decade of economic unification, Germany has become the engine for the European economic integration again during the 2008 global crisis (Foders and Vogelsang 2014). With the exception of Hungary, the other Visegrád countries (Poland, Slovakia and the Czech Republic) had not accumulated notable disequilibria prior to the crisis and they suffered from the smallest decline of growth rate among the CEE countries during the crisis (Farkas 2012). These processes resulted in raising interest in the research of Central European region.

Germany has been a traditionally large trading partner for East-Central Europe since the late nineteenth century. The origins of current economic relationship with Visegrád countries date to German Ostpolitik of the 1970s. Using the détente and the end of Cold War, Chancellor Willy Brandt normalized political relations with Germany's eastern neighbours. The Ostpolitik paved the way for West German companies to move to the Eastern bloc. The 1970s were the period of economic stagnation after the extensive growth of socialist industrialization that induced the Soviet bloc to cooperate with Western partners. From 1968 to 1978 the German trade with Poland, Hungary and Czechoslovakia nearly quadrupled. After the collapse of communist systems, the relationships changed qualitatively and in the 1990s German direct investment surged into the region. This FDI enabled German companies to incorporate East-Central European subsidiaries into their production chain by the early 2000s (Gross 2013).

Germany has become the first export and import partners in each Visegrád country and Germany has accounted for 25-30 per cent of their exports and imports. (German trade represents the largest share in the Czech Republic and the smallest one in Slovakia.) It is not surprising that the smaller and less developed countries are dependent on German economy but this dependency is mutual. Selecting the top three and some traditionally important trading partners, the outstanding role of the Visegrád group is remarkable (Figure 1).

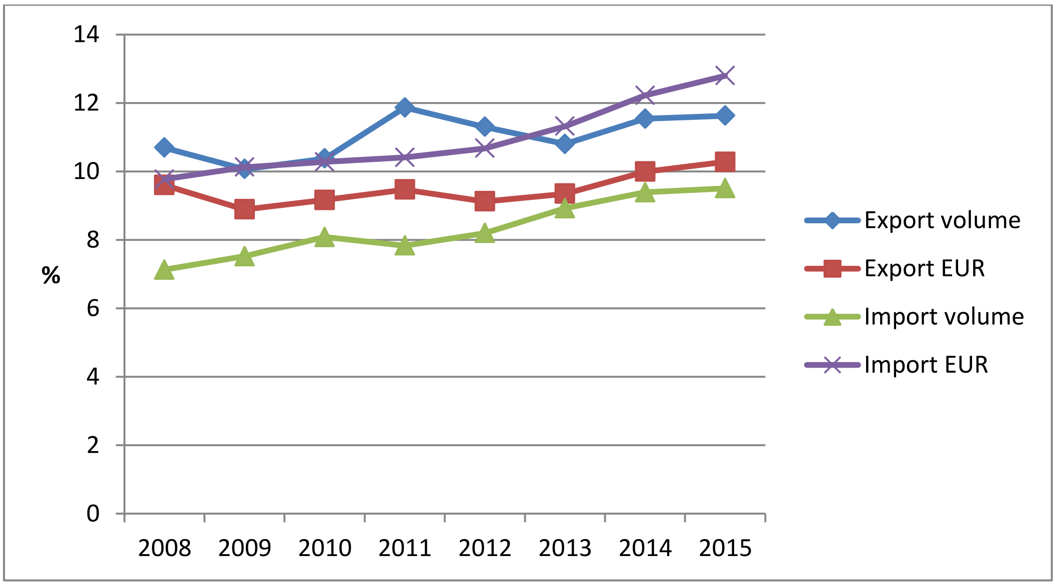
Figure 1. Germany's exports and imports with selected trading partners in 2014




Source: Statistisches Bundesamt 2015: 415-416

Since the 2008 global crisis, the share of Visegrád countries in Germany's exports and imports has slightly increased measured in both volume and EUR (Figure 2).

Figure 2. The share of Visegrád countries in Germany's exports and imports, 2008-2015




Source: Statistisches Bundesamt (2016), own calculation

The strong trade linkages reflect the integration of  Visegrád countries into the German-Central European supply chain which is indicated by the high prevalence of trade in intermediate goods (Table 1).

Table 1. Exports of Visegrád countries and Germany in % of nominal GDP

| | 1996 | | 2011 | |
|---|---|---|---|---|
| | Visegrád countries | Germany | Visegrád countries | Germany |
| **Total exports** | 30.1 | 24.3 | 52.8 | 47.7 |
| to Visegrád countries | | 1.4 | | 4.5 |
| to Germany | 8.4 | | 16.6 | |
| **Final goods** | 21.4 | 17.8 | 38.9 | 35.0 |
| to Visegrád countries | | 0.9 | | 2.8 |
| to Germany | 6.0 | | 11.2 | |
| **Intermediate goods** | 8.7 | 6.5 | 13.9 | 12.3 |
| to Visegrád countries | | 0.5 | | 1.6 |
| to Germany | 2.4 | | 5.4 | |
| **Size** (in % of world GDP) | 0.9 | 8.0 | 1.4 | 5.1 |

Source: Elekdag and Muir 2013: 9

*The Central European manufacturing core*

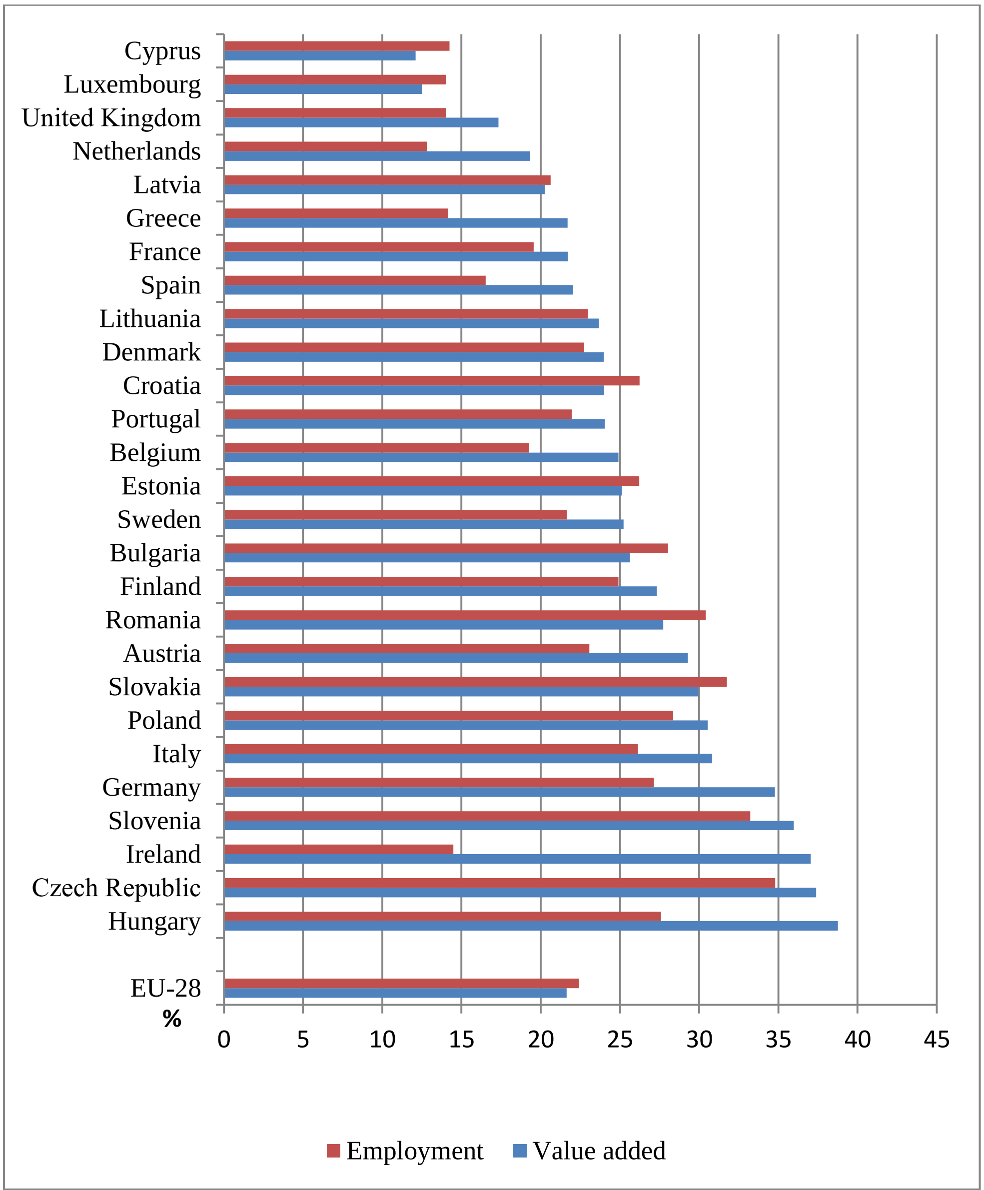
In the modernization of manufacturing bases in Visegrád countries German FDI played a crucial role. In the early 2000s one quarter of German FDI went into manufacturing in which automotive industry has special importance. As a result, this region, next to China, has become the world's fastest growing automotive production location (Kőrösi 2014; Gross 2013).

The relative importance of their manufacturing is salient in the EU. Among the first nine countries which have the largest share of value added in manufacturing, there are only two, Ireland and Italy which do not belong to the Central European manufacturing core (Figure 3).

The manufacturing sector is a source of technological progress and an expected advantage of FDI inflows that they promote technological transfer. The change of export structures and revealed comparative advantages (RCA) in manufacturing show that transformation in Visegrad countries complies with the expectation based on literature. Between 1995 and 2009 the RCA increased in knowledge-intensive sector the most substantially (Table 2). In the EU the share of advanced manufacturing value added of the Central European manufacturing core (including Austria) increased from 39.2 per cent  to 47.2 per cent between 1995 and 2011 (Stehrer and Stöllinger 2015: 9).

Figure 3. Relative importance of manufacturing (NACE Section C), 2012

(% share of value added and employment in the non-financial business economy total)




Source: Eurostat

Table 2. Revealed Comparative Advantage in manufacturing

| | 1995 | | | 2009 | | |
|---|---|---|---|---|---|---|
| | Labour-intensive | Capital-intensive | Knowledge-intensive | Labour-intensive | Capital-intensive | Knowledge-intensive |
| Germany | 0.64 | 1.07 | 1.48 | 0.64 | 1.20 | 1.49 |
| Czech Rep. | 1.29 | 1.30 | 0.56 | 1.01 | 1.16 | 1.18 |
| Hungary | 0.68 | 1.06 | 0.50 | 0.37 | 0.77 | 1.18 |
| Poland | 1.95 | 1.39 | 0.59 | 1.52 | 1.39 | 0.93 |
| Slovakia | 1.05 | 1.61 | 0.60 | 1.16 | 1.41 | 1.11 |

Source: IMF 2013: 9

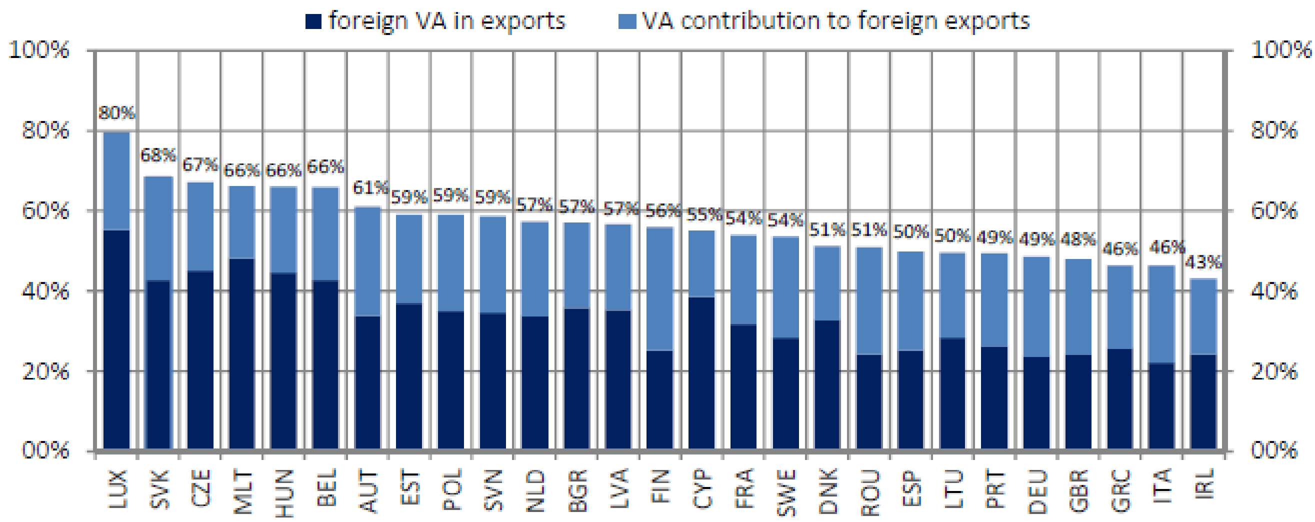
Recently two research reports, an IMF Staff Report (IMF 2013) and the study of the Austrian Research Centre FIW (Forschungsschwerpunkt Internationale Wirtschaft) (Stehrer and Stöllinger 2015) thoroughly analysed the Central European supply chain. Both of them provide a very favourable picture on economic cooperation in the region.

The econometric model of IMF researchers suggests that – with the exemption of Hungary – Visegrád countries have grown more rapidly than can be explained by initial income. Presumably the participation in the supply chain accelerated income convergence. As a significant part of the countries‘ exports are intermediate goods that are processed and re-exported by a third economy, Visegrád countries are not so vulnerable to domestic demand shocks in Germany as the data of traditional trade statistics indicate. Greater trade openness has increased the vulnerability of both Germany and Visegrád countries rather to global shocks (IMF 2013).

To assess the economic relations between Germany and Visegrád countries, the crucial point is the analysis of production sharing in the supply chain. The IMF Staff Report (2013) emphasizes that on the one hand, the shares of domestic value in gross export have broadly declined in Visegrád countries between 1995 and 2009, but on the other hand, they have increased significantly in nominal terms and as a percentage of GDP. That is, the growth in foreign value added in their exports has spurred domestic value added. Based on their knowledge-intensive sector, if they invest in human capital, Visegrád countries can become “upstream” countries and the Report refers to the example of China.

The IMF Report does not highlight the different roles and positions in the supply chain and important aspects remain unrevealed. The in-depth analysis of the FIW study provides a more complex investigation. The participation in the global value chain (GVC) is defined as the sum of the foreign value added in a country’s exports and the country’s value added contributions to other countries’ exports, expressed as a percentage of gross exports. Visegrád countries have very high rankings in GVC participation rate. The low ranking of Germany is due to the country size. The important difference is that the foreign value added content in domestic exports contributes to a larger extent to the GVC participation in Visegrád countries than not only in Germany but in Austria, which is also a member of the Central European manufacturing core (Figure 4.) Their econometric model strengthens the well-known fact that relative lower wages and geographic proximity to Germany foster production integration. The Central European supply chain is driven by the activities of German leading companies. However the country size does not determine the role in the production integration. Austria does not have a leading role; however it is not an offshoring destination like Visegrád countries but a supplier of specialised inputs that is technology provider, like Germany (Stehrer and Stöllinger 2015).

Figure 4. The EU-27 ranked according to the GVC participation rate



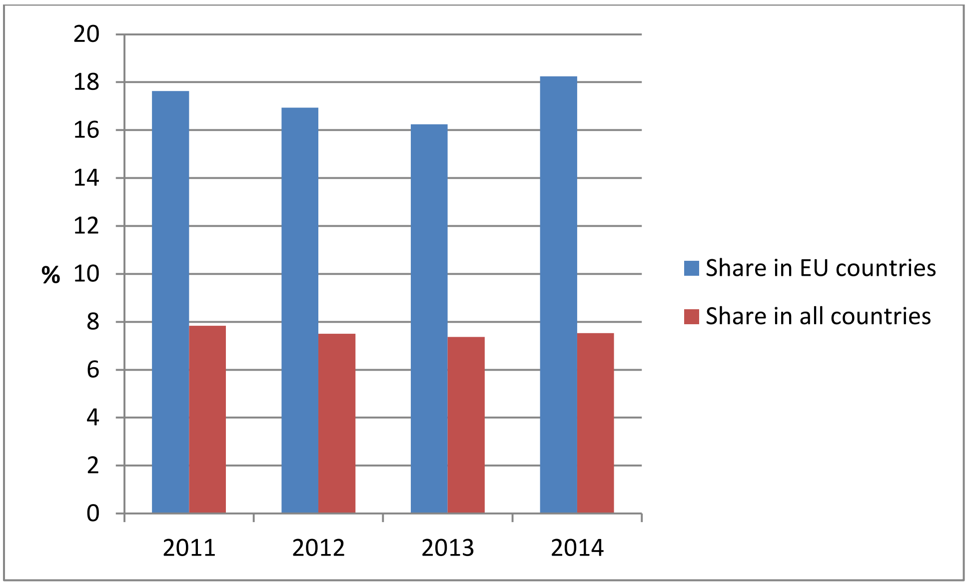

Source: Stehrer and Stöllinger 2015: 20

*FDI inflows into Visegrád countries since the 2008 global crisis*

As we have seen above, German FDI inflows had a decisive role in the development of Central European manufacturing core. Visegrád countries have been important destination of German FDI since the 2008 global crisis as well. In the last years the share of Visegrád countries in the total German outward stock is about 7.5 per cent, in the German outward stock in the EU countries between 16 and 18 per cent (Figure 5).

Germany is one of the major partners among the home countries of FDI in the Visegrád group: the third in Czech Republic, the first in Hungary, the second in Poland and the fifth in Slovakia. German FDI stock in these countries amounted 6.7-23 per cent of their total FDI inward stock in 2014 (Table 2).

Figure 5. The share of Visegrád countries in German FDI outward stock, 2011-2014




Source: Deutsche Bundesbank 2016, own calculation

Table 2. Inward FDI stock in Visegrád countries from Germany in EUR (million) and the share of Germany in their total inward FDI stock

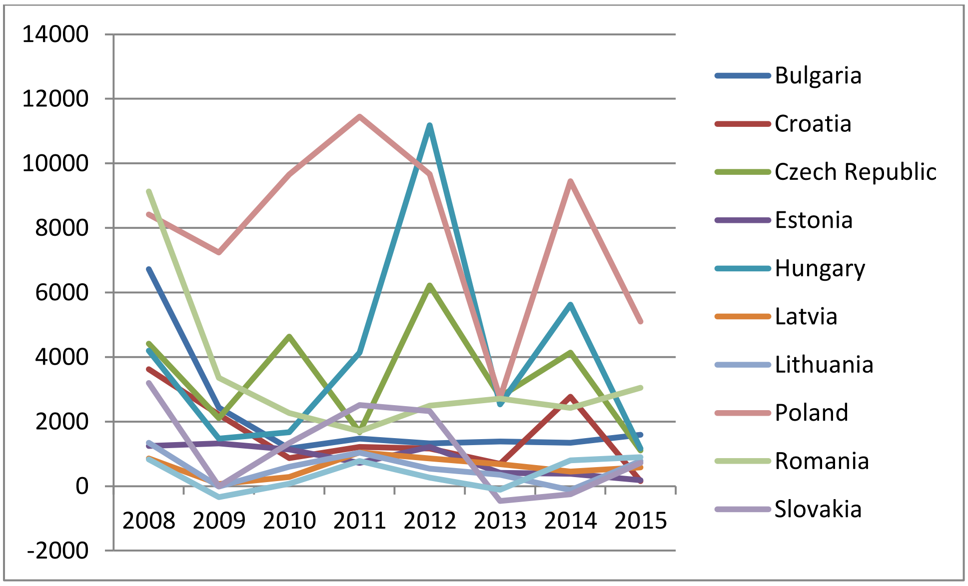
| | 2011 | 2012 | 2013 | 2014 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|
| | EUR million | | | | in % of total | | | |
| Poland | 21.482 | 26.898 | 28.115 | 27.979 | 13.7 | 15.1 | 16.7 | 16.3 |
| Hungary | 19.371 | 19.500 | 19.076 | 18.710 | 29.3 | 24.7 | 24.2 | 23.0 |
| Czech Rep. | 13.906 | 14.533 | 10.978 | 12.600 | 14.9 | 14.0 | 11.3 | 12.6 |
| Slovakia | 4.459 | 4.511 | 3.284 | 2.877 | 11.1 | 10.8 | 7.8 | 6.7 |

Source: Hunya and Schwarzhappel 2016: 81, 89, 101, 109

Both above mentioned reports emphasize the current advantages of Central European manufacturing core and the significance of German FDI in the development of the supply chain. If the development perspectives of the current production sharing is taken into consideration, the literature suggests that the opportunity of upgrading in GVC is a more difficult task than the reference to China in the IMF Report (2013) indicates (e.g. Capik and Drahokoupil 2011; Rugraff, E. and Hansen 2011). Based on a very thorough literature Sass and Szalavetz (2014: 65) summarize the 2008 global crisis related changes in GVCs: “The consequence for advanced countries is greater specialization in the activities requiring higher skills at the two ends of the GVC, while reliance on less-advanced countries with lower wages in the ‘middle’ of the GVCs has grown more robust.” Although there are successful examples of upgrading (Szalavetz 2016), the current production sharing in Central European manufacturing core projects difficulties in the long run convergence.

However, this paper focuses on the short term development and since the global crisis new features of FDI have emerged in CEE. FDI inflows fluctuation has become extremely volatile (Figure 6) and there is no close connection with economic growth or changes in business environment. Capital reserves, profits and losses are moving within multinational companies in various forms of FDI. Tax optimisation seems to be more important in the choice of a host country than it was prior to the crisis. FDI has become much smaller than they were before the crisis and they did not increase even in the global FDI upturn in 2015. Germany remains a major investor in CEE in 2016. However, the Association of German Chambers of Commerce and Industry survey sees that CEE is losing out its importance for larger markets. In some countries investors have problems with the transparency of public procurement, corruption and technical education. A growing shortage of qualified labour is seen as a main obstacle to investment in the Czech Republic, Hungary and Slovakia (Hunya and Schwarzhappel 2016).

Figure 6. FDI inflows into the CEE countries, 2008-2015, EUR million




Source: Hunya and Schwarzhappel 2016

*Germany's and Visegrád countries' positions in the migration policy debate*

Since their EU membership, Visegrád countries have been the supporters of German economic policy in the EU. Poland, the Czech Republic and Slovakia followed disciplined fiscal policies. Hungary was placed under excessive deficit procedure between 2004 and 2013 but Hungarian governments were not theoretical opponents of strict fiscal policy even in this period. The support of Visegrád countries (and of the CEE countries) took on significance during the 2008 global crisis, more precisely during the euro zone crisis when a deep split between "the North" and "the South" appeared. Visegrád countries were interested in stabilization of the euro zone and accepted German leadership. The strength of bilateral political relations was different, some tensions emerged (e. g. concerning the relation with Russia, cautious German criticism of the Hungarian (Orbán) government since 2010) but the Germany-Visegrád relations were basically harmonious (Handl and Paterson 2013).

The migration crisis in 2015 has brought a radical change in these relations. The Visegrád cooperation, which has very mixed past experiences (Fawn 2013; Kiss 2015), has strengthened and common position has been formed on migration issues.

The German position has been based on the strong Western European commitment to human rights and the immediate labour demand in ageing society. Chancellor Merkel tried to use the German distribution mechanism of refugees and this idea appeared in the European Commission's proposal.

Visegrád countries are also ageing societies, but they enjoyed national sovereignty for short periods in their history (Slovakia first time since 1993) and the majority of their population rejects the idea of multicultural society. In Slovakia, Hungary and the Czech Republic, Roma minority amounts 5-10 per cent (and growing share) of population. Politicians and public administration are unable to reach the roots of their segregation and integration projects fail time to time. Additionally, it is assumed that in a European distribution of refugees/migrants better educated people would go to richer Western countries. Poorly educated people could not promote economic growth in CEE but they would generate large expenditures. Beside the discouraging Roma integration experience, the prevalent attitude in CEE is that these countries - being European nations – are entitled to EU (Western) support as compensation for the lost decades under Soviet communism and for the extra high profits which were earned by the multinational companies during the economic transformation and privatisation.[3] Contrary to the warning of some Western politicians, the support of EU Funds is not regarded as a gesture of solidarity which would oblige for gestures of solidarity towards refugees/migrants. Politicians have strengthened the existing attitudes in Visegrád societies and they use the problems of migration in their power games. The Orbán government had a pioneer role in the region and a referendum is organised about the European refugee

[3] Kőrösi (2014) estimates the net profit rate of foreign companies 7-8 per cent in Hungary prior to the crisis, contrary to the 2-2.5 per cent in the manufacturing firms of EU-15.

relocation scheme on 2 October. According to a Hungarian public opinion survey, 64 per cent of respondents considered moral obligation to help refugees in September 2015, and only 35 per cent in September 2016; one year ago, 37 per cent of respondents thought that Hungary should take refugees complying with its economic capacity, in September 2016 only 21 per cent.[4] The impact of terrorist attacks in several European cities and the referendum campaign has changed the public opinion.

*Future scenarios in Central European relations*

As a conclusion, we can outline possible scenarios on the future of German-Visegrád relations. This paper does not analyse the very complex issue of migration and I assume that migration will be managed somehow (possible natural or political catastrophes are not taken into consideration).

1. Eroding relations.

This is the less possible scenario. Even if the growth of Central European manufacturing core slowdowns, the embeddedness of the partners in it impedes that they change their economic partners. Additionally, the large EU members, France and Italy, which seem to be closer political partners, do not share Germany's economic view. For Southern Europeans the closer, deeper integration means transfer union which is frightening for Germany.

2. Converging views and developing economic relations.

One the one hand, Germans would be more sensitive to the desires and historical experiences of Visegrád countries. One the other hand, these countries accept that the desire for Western living standards, historical miseries and injuries do not absolve of the obligation of humanitarian assistance. A mix of feasible migration policy and family supporting population policy ensure the sustainable economic development and European cultural continuity. Unfortunately, this is also an unlikely scenario. It is extremely difficult to compose such a policy mix and these issues are captured by political games.

[4] http://www.publicus.hu/blog/kvotanepszavazas_novekvo_idegenellenesseg_valtozatlan_reszveteli_szand/ (downloaded on 4 September)

3. Muddling through.

This is the most likely scenario. Both sides, Germany and Visegrád countries realise their economic and political barriers and in the midst of political tensions economic relations develop at a slower pace – not because of political but demographic reasons.

4. Convergence between Germany and Visegrád countries via “Eastern Europeanisation”.

It is not likely but not impossible. When I finish this paper, AfD seems to beat CDU in regional elections of Mecklenburg-Vorpommern…

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