How to Make CESEE's Public Finance Systems More Crisis-Resilient and Improve Their Macroeconomic Stabilization Capacity?

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1. Introduction

Crises are not only sources of economic disruptions, but they offer opportunities to learn. This is valid also for the last global crisis, which has provided more valuable insights into the issues of capacity to implement stabilization policies than any debt-sustainability, stress-testing or other similar theoretical exercise. What are the main lessons from the last crisis?

When focusing on fiscal policy, the debate about stabilization capacity is usually set in a framework of fiscal space, which is seen as a capability to implement discretionary fiscal relaxation in a moment of recession. We would argue however for a broader concept of the fiscal space that would also cover the policies of letting automatic stabilizers operate. After all, the presence of financing constraints might prevent governments to allow automatic stabilizers to operate even partially, not only to implement a discretionary fiscal stimulus.

The broader concept of fiscal space is particularly relevant for the CESEE region. As these economies are all small and open in the usual sense, the old arguments against discretionary fiscal stimulus for all of them remain valid. In particular, the fiscal multipliers in such countries are for sure lower than 0.5, and perhaps as low as 0.3, with Poland possibly being the only exception. We also know that multipliers might turn to be negative if a country lacks fiscal credibility: The additional budget spending in such cases might further erode the confidence of households and investors.

Moreover, it should not be taken for granted that the policy of letting the automatic stabilizers *to operate fully* is necessarily optimal even if the country was

[1] This presentation reflects the author's views and not necessarily the views of the Croatian central bank and management.

in a reasonable fiscal shape before the crisis had hit. This is because one of the lessons of the recent events is that crises cannot only temporarily reduce the level of output below an otherwise unchanged potential growth path, but that they can also lead to a permanent downward correction in both the level and growth of the potential output. In such an environment, sticking to automatic stabilizers, i.e. leaving expenditure on a pre-crisis path, could lead to a fast and unsustainable accumulation of government debt. We may say that in such circumstances automatic stabilizers can easily turn into automatic destabilizers.

This point has been clearly demonstrated by the fact that for many countries the estimates of potential output have been ex-post sharply revised down compared to the previous real-time estimates. As a result, what looked as a sustainable structural balance before the crisis might ex-post turn out to be unsustainable. And if the structural fiscal balances ex-post is much weaker than the one estimated ex-ante, one can see why letting the automatic stabilizers operate fully might quickly erode fiscal credibility.

Furthermore, regardless of the ex-post revisions of potential output in the past, even more important are revisions of the estimated prospective growth. Once potential growth rate and level have been revised down, defining optimal policy in such circumstances would require that the transitory effect of the crisis that can be accommodated by the stabilizer mechanism is disentangled from the permanent effect that can only be addressed by expenditure cuts or tax increases. In fact, unless you want to end up going out of crisis with a permanently increased tax burden, the only solution is to start cutting expenditures relative to their pre-crisis path. This means that in such a situation letting the automatic stabilizers operate fully might not be an optimal policy.

Mentioning all these qualifications, let us turn to the issue of how much fiscal space did CESEE countries have during the crisis, which factors had determined their fiscal space, and how did they use it.

2. How Did the Crisis Hit the CESEE Countries and How Did They React?

The crisis hit the CESEE countries through both the trade channel and the financial channel. However, in addition to the immediate effects of these external shocks, the crisis has also triggered long-overdue adjustment in current account imbalances in the majority of the European post-transition countries. The trade channel shock is by now over, but the process of adjustment to a new growth model, which will require lower external account imbalances, is still ahead. This is the reason that not only the growth shock in CESEE region was larger than in other emerging market economies during the peak of the crisis, but weaker growth performance is expected in the future as well (table 1 and chart 1).

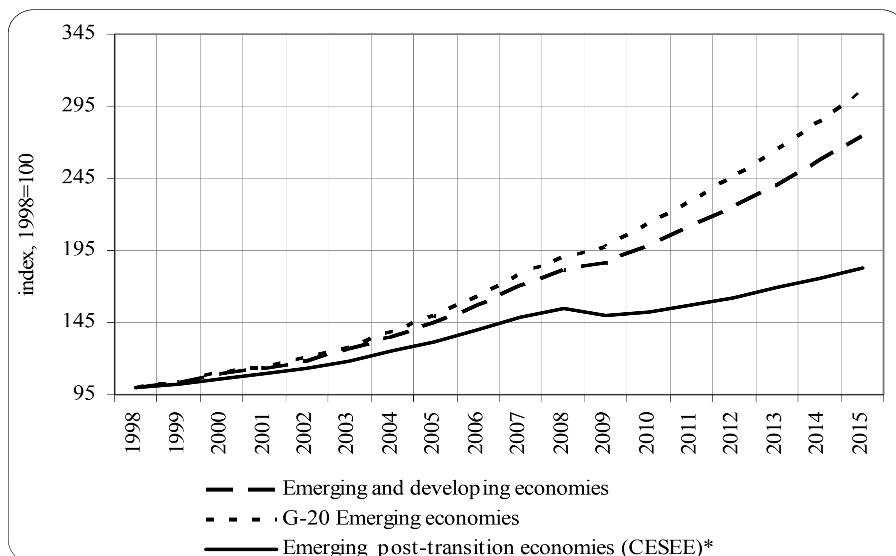
Table 1: Change in GDP Growth Rate 2007–2009

in percent	**2007**	**2009**	**change 2007–2009**
G-20 advanced	2.3	-3.2	5.6
G-20 emerging	9.7	3.5	6.2
CEE	6.4	-2.7	9.0
SEE	6.2	-5.9	12.1
Czech Republic	6.1	-4.1	10.3
Slovakia	10.6	-4.7	15.2
Slovenia	6.8	-7.8	14.6
Poland	6.8	1.7	5.1
Estonia	6.9	-13.9	20.8
Latvia	10.0	-18.0	27.9
Lithuania	9.8	-14.8	24.6
Hungary	1.0	-6.3	7.3
Bulgaria	6.2	-5.0	11.2
Croatia	5.5	-5.8	11.3
Romania	6.3	-7.1	13.5
Serbia	6.9	-3.0	9.9

Source: IMF, World Economic Outlook Database, October 2010.

Note: The change in GDP growth rates between 2007 and 2009 was the largest in the post-transition European countries.

Chart 1: Growth in the Post-Transition and Emerging Market Economies



** Includes also the Czech Republic, Slovakia and Slovenia.*

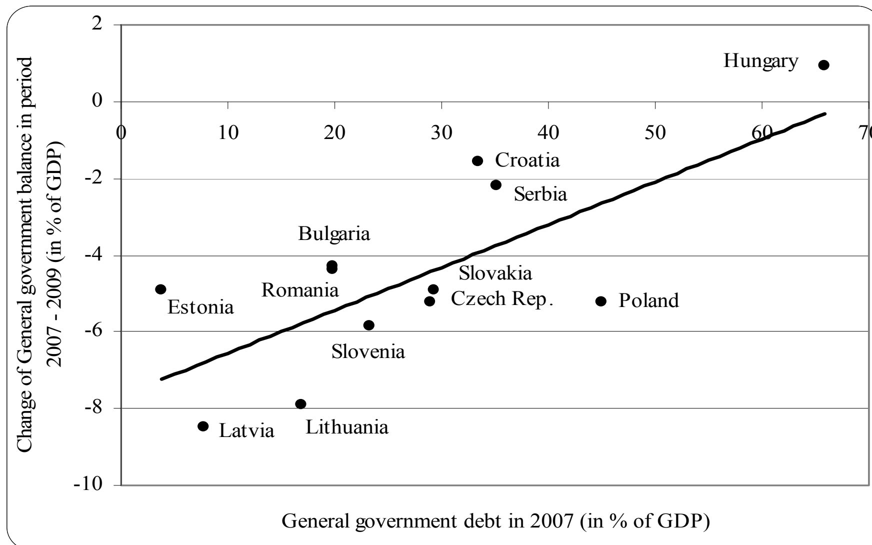
Note: In post-transition countries growth will decelerate relative to the pre-crisis times.

Source: The IMF WEO database, October 2010 vintage.

Facing large output shocks, all countries in the CESEE region let their fiscal balances expand, except for Hungary. The degree of fiscal expansion in 2007–2009 shows a surprisingly strong correlation with the starting fiscal position (charts 2 and 3). The public debt ratio was lower in 2007 when more expansion in the headline fiscal balance had the countries allowed over the next two years. Somewhat weaker is the correlation between the budget balance in 2007 and the relaxation, with the outliers being two currency-board countries Estonia and Bulgaria.
The figures would suggest that fiscal space of individual countries was determined by their fiscal position at the onset of the crisis.

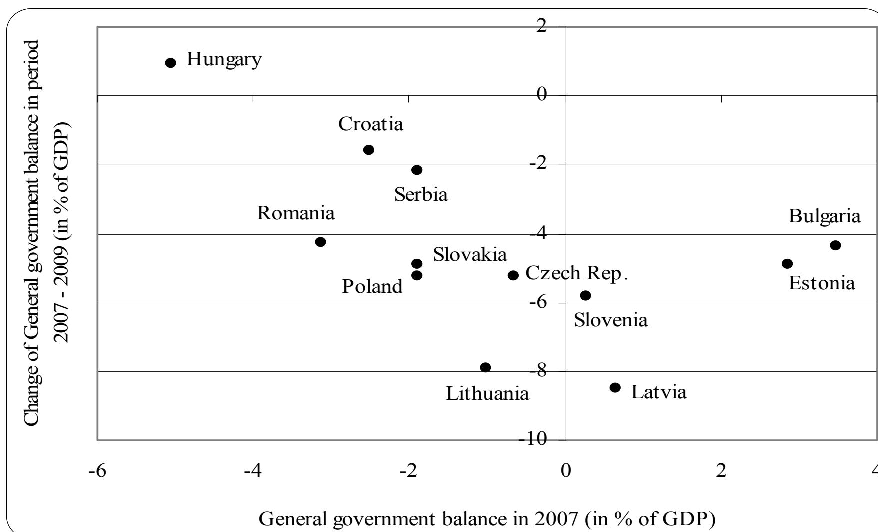
However, this is just a part of the story. To get the whole picture, one needs to look which countries managed to allow the fiscal expansion without adversely affecting their access to financial markets. This can best be seen by looking at the Credit Default Swap (CDS) sovereign spreads for the region.

Chart 2: Public Debt Ratio in 2007 and the Worsening in Fiscal Balance 2007–2009



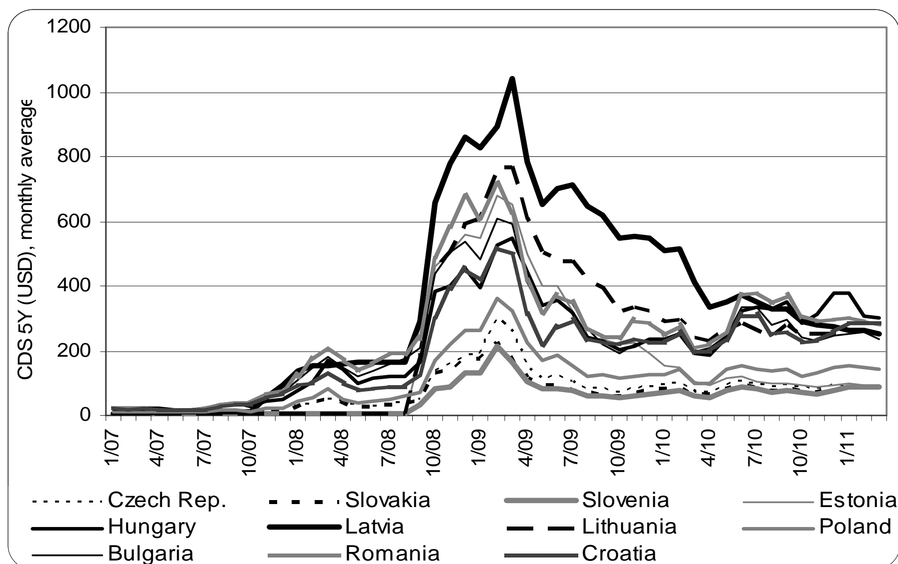
Source: IMF WEO database, October 2010 vintage.

Chart 3: General Government Balance in 2007 and Subsequent Relaxation 2007–2009



Source: IMF WEO database, October 2010 vintage.

Chart 4: Sovereign CDS in the CESEE Region



Source: IMF WEO database, October 2010 vintage.

While there was obviously a strong common component driving the CDS spreads, it is also clear that since the Lehman Brothers bankruptcy markets have started to differentiate between the individual countries. For three countries, spreads remained quite low during the whole period, indicating that they had fully preserved access to private capital markets. These were the Czech Republic, Slovakia and Slovenia. Poland has been close to these three countries, but still not quite in the same league. And while Estonia's spread has recently approached those of the best performers, this occurred only after markets became convinced that the country would start enjoying the euro area safety net.

All other countries in the region saw their spreads substantially deteriorating, indicating that their access to private financing has limited their fiscal space.
Which variables best discriminate among countries that were affected by the deteriorating spreads from those that were not?

Table 2: Factors Limiting Access to International Markets

in percent of GDP, unless otherwise indicated	**CDS 5Y (USD)**	**General government balance**			**Current account balance**	**General government debt**
	Q3/2010	**2007**	**Change 2009-2007**	**2010p**	**2007**	**2007**
Czech Republic	93.1	-0.7	-5.2	-5.4	-3.3	29.0
Slovakia	83.1	-1.9	-4.9	-8.0	-5.3	29.3
Slovenia	76.6	0.3	-5.8	-5.7	-4.8	23.3
Poland	140.1	-1.9	-5.2	-7.4	-4.8	45.0
Estonia	100.8	2.9	-4.9	-1.1	-17.2	3.7
Latvia	337.1	0.6	-8.5	-11.9	-22.3	7.8
Lithuania	262.7	-1.0	-7.9	-7.7	-14.6	16.9
Hungary	335.9	-5.0	0.9	-4.2	-6.5	65.8
Bulgaria	302.4	3.5	-4.4	-4.9	-26.9	19.8
Croatia	272.0	-2.5	-1.6	-6.2	-7.6	33.4
Romania	364.9	-3.1	-4.3	-6.8	-13.4	19.8
Serbia	347.5	-1.9	-2.2	-4.8	-16.0	35.2

Sources: Bloomberg; International Monetary Fund, World Economic Outlook Database, October 2010.

If we look at the best performers, i.e. those that did not see their spreads substantially deteriorating, we see that they had the following in common: A public debt ratio at the onset of the crisis lower than 30% of GDP, a budget deficit lower than 3% of GDP, and a current account deficit lower than 6% of GDP. These indicators seem to qualify a country for the club of the least affected. Poland which had a somewhat higher public debt ratio and had aggressively relaxed its fiscal policy, did not do so well and saw its spreads elevating.

It is important to note that the current account deficit, a non-fiscal indicator, has proved to be important for fiscal space. This has reflected the fact that markets in such a situation became concerned about the implications of the external imbalances on both the prospective budget performance and GDP growth prospects.[2]

[2] It is of course the underlying current account balance that matters, i.e. the one from which the effect of both domestic and partner country cycles are eliminated. However, with cycles being synchronised, the headline balance provides good approximation of external vulnerability.

We can therefore summarize this section by saying that the crisis has split the CESEE countries in 3 groups:

1. Countries that entered the crisis in a good fiscal position and without external imbalances. These countries were able to afford expansionary fiscal policy, including discretionary relaxation without seeing their sovereign spreads substantially deteriorating. These countries were the Czech Republic, the Slovak Republic and Slovenia. Poland was a border case as it started with a higher level of public debt, aggressively expanded the deficit and had to seek IMF credit-line to make investors less nervous.

2. Countries with low public debt and favorable budget balance, but large external imbalances. They saw their spreads shooting up and the access to private capital becoming constrained. While countries in this group still let their headline fiscal deficits expand (but abstained from discretionary stimulus), they had to finance them either from their budgetary reserves, or the IMF and the EU. The EU in fact helped not only via formal emergency lending arrangements, but also by accelerating regular regional assistance programs. However, while they managed to finance the expanded fiscal deficits, these countries did not preserve satisfactory market access, as reflected in their spreads. Countries in this group were Baltics and Bulgaria.

3. The remaining countries in the region saw their spreads deteriorating and the access to private financing becoming constrained. Some of them turned to the IMF who was willing to approve soft programs in 2009, while others limited the deterioration in the headline deficits. Had they tried to borrow more aggressively in international markets, they would have most likely hit the wall. The outlier in the group is Hungary, which even achieved an improvement in the headline balance during the crisis, which translates in almost 5 percentage points of GDP improvement in the structural balance between 2007 and 2009.

3. Looking Forward: Do the Current Fiscal Positions of the CESEE Countries Ensure that They Would Have Fiscal Space in a Possible New Crisis?

The lesson from the last crisis appears to be simple: If you want to have fiscal space when a crisis hits, make sure you have a low public debt ratio, possibly below 30% of GDP, that your structural deficit is close to zero, and that the economy does not have a large external imbalance. The exact "safe" threshold for the public debt ratio might of course be debated. Until the last crisis, it was generally considered that the ceiling for emerging market economies was 40% of GDP. If anything, the current crisis would suggest that it is lower.

Where are the countries of the CESEE region relative to such indicators today?

Table 3: Selected Indicators for CESEE Countries

in percent of GDP, unless otherwise indicated	**General government balance** (headline)			**General government cyclically adjusted balance** (in % of potential GDP)			**General government cyclically adjusted primary balance** (in % of potential GDP)	**General government gross debt**		
	2009	**2010**	**2011**	**2009**	**2010**	**2011**	**2011**	**2007**	**2015**	**change 2007-2015**
Czech Republic	-5.9	-5.4	-5.6	-4.6	-4.4	-4.7	-3.0	29.0	56.9	28.0
Slovakia	-6.8	-8.0	-4.7	-5.8	-6.9	-4.1	-2.4	29.3	43.9	14.5
Slovenia	-5.6	-5.7	-4.3	-4.3	-3.9	-2.7	-1.4	23.3	35.6	12.2
Estonia	-2.1	-1.1	-1.7	n/a	n/a	n/a	n/a	3.7	18.7	14.9
Hungary	-4.1	-4.2	-4.5	-0.9	-1.1	-1.7	1.9	65.8	82.5	16.6
Latvia	-7.8	-11.9	-7.6	n/a	n/a	n/a	n/a	7.8	35.5	27.7
Lithuania	-8.9	-7.7	-7.7	-5.7	-5.8	-6.5	-4.2	16.9	57.3	40.3
Poland	-7.1	-7.4	-6.7	-6.8	-7.1	-6.6	-3.5	45.0	60.9	15.9
CEE	**-6.4**	**-6.6**	**-5.9**	**-5.3**	**-5.6**	**-5.2**	**-2.5**	**39.6**	**59.1**	**19.5**
Bulgaria	-0.9	-4.9	-4.2	0.0	-2.7	-2.0	-1.4	19.8	27.7	8.0
Romania	-7.4	-6.8	-4.4	-6.6	-4.1	-1.8	-0.1	19.8	33.2	13.4
Croatia	-4.1	-5.2	-5.6	-3.5	-4.5	-5.4	-3.2	33.4	46.1	12.6
Serbia	-4.1	-4.8	n/a	n/a	n/a	n/a	n/a	35.2	34.3	-1.0
SEE	**-5.2**	**-5.9**	**-4.6**	**-4.6**	**-3.9**	**-2.5**	**-1.0**	**24.3**	**34.3**	**9.9**
CESEE	**-6.1**	**-6.4**	**-5.6**	**-5.2**	**-5.2**	**-4.6**	**-2.2**	**35.6**	**52.7**	**17.1**

Source: IMF WEO database, October 2010 vintage.

In the CESEE region, between 2007 and 2015, the public debt ratio is set to deteriorate by about 20 percentage points of GDP, reaching on average about 60% of GDP. The structural or cyclically adjusted deficit in 2010 is estimated for these countries at 5.6 percent of GDP, quite far from "close to balance over the cycle". The cyclically adjusted primary balance is heavily negative at some –2.5% of GDP, on average. All these indicators are far from safe levels, although admittedly, the deterioration is smaller than in the advanced economies.

In the SEE region, the deterioration in the public debt ratios will be only 10 percentage points, but countries in that group still have a problem with the

underlying current account balance, which will or has already triggered market concerns. (While the headline external account deficits have declined across the region, at this point it is difficult to estimate to which extent their structural balances have improved).

Only three countries, Slovakia, Romania and Latvia are on the path to adjust the structural balance by more than 2 percentage points in 2011, with Slovenia trailing with a smaller but still sizable adjustment higher than 1 percentage point. No major consolidation measures are envisaged in other countries.

Furthermore, recent simulations performed by the IMF staff on the necessary adjustment that would need to be accomplished by 2020 so as to achieve a safe level of public debt by 2030 indicate that some of the countries in the region indeed face big challenges (table 4).

Table 4: Primary Balance in 2010 and the Necessary Adjustment

in percent of GDP	**Cyclically adjusted primary balance in 2010**	**Adjustment to achieve prudent debt limit in 2030**
Czech Republic	-3.1	4.3
Slovakia	-5.9	6.8
Slovenia	-2.8	3.4
Poland	-4.3	6.8
Estonia	2.4	-1.7
Latvia	-6.4	6.6
Lithuania	-4.5	6.6
Hungary	2.5	0.8
Bulgaria	-2.5	3.4
Croatia	-0.8	n/a
Romania	-2.7	3.0
Serbia	-4.6	n/a

Source: IMF Fiscal Monitor, November 2010.

We can conclude therefore that the crisis has led to a large deterioration in the fiscal balances in the CESEE countries. While the debt ratio will deteriorate less than in the advanced economies, it will nevertheless increase much above the safe level. As a result, unless they start quickly to implement fiscal consolidation, the majority of the countries will have much less fiscal space in a possible future crisis than they had in 2008/09.

4. How to Create Fiscal Space and What to Avoid?

Markets will continue to perceive an increased risk of sovereign defaults in the years ahead. This suggests need for a prompt action. At this point, the CESEE region benefits from uncertainties about sovereign risks in Western Europe in two ways. First, investors who want exposure to Europe perceive at this stage the CESEE region as safer. Second, the fact that the public debt ratio in the advanced economies will grow by some 35 percentage points between 2007 and 2015 has distracted attention from the deterioration in the CESEE region. However, this might change. The CESEE countries should therefore signal soon that they are serious about fiscal consolidation.

Approving credible medium-term fiscal frameworks should be crucial in this context. Such frameworks should explicitly aim at reducing debt ratios to the pre-crisis level over some reasonable time-horizon and be based on conservative estimates about potential output growth. Moreover, using absorption gaps might be more appropriate than using output gaps for estimating the structural balances. The former would correct revenue not only for the output boom but also for excessive current account deficits.

Strengthening transparency should certainly be part of such credible frameworks. After all, markets reacted vehemently to Greece's fiscal prolificacy, once it became known how misleading its fiscal statistics were. Against this background, various questionable methods that started to be used by several countries in the region with a view to meeting fiscal targets are not encouraging. For example, re-directing second pillar pension contributions to the budget obviously does not reduce the actual public debt, unless these resources are definitely expropriated from the private sector. And even if the government does not intend to compensate the contributors in the future, it will not be able to avoid taking over pension obligations, which in fact might effectively result in an even larger public debt.

The composition of fiscal measures should also preferably be focused on the expenditure side so as to avoid weakening in competitiveness. Based on the measures implemented so far, many countries in the region will exit the crisis with a higher tax burden than they entered the crisis.

Regarding the argument that fiscal space in some countries was adversely affected by the excessive reliance on indirect taxes, which fell more than income during the crisis, and that post-crisis reforms should address this issue, I would argue that this would be wrong medicine based on a wrong diagnosis. Structural fiscal balances indeed get overestimated if underlying revenue is overestimated. But this does not require that consumption be taxed less, only that the transitory revenue is appropriately accounted for.

Regarding the point that new multilateral financing mechanisms should be established so as to increase fiscal space for the countries, I would say that there is

no evidence that more expansionary fiscal policy was desirable for any country in the region. Hungary might be an exception, but here the weak fiscal performance in the past played probably a crucial role in preventing a softer approach during the crisis. Moreover, no country in the region has faced a balance of payment crisis because of the absence of external financing. Instead, several countries took advantage of the soft IMF programs in 2009 that facilitated not only the balance of payments assistance but also directly provided budget support.