

# **Limited Fiscal Space in CESEE: The Issue, Underlying Economic Conditions, Related Implications and Policy Options**

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## **1. Limited Fiscal Space: The Issue**

The extraordinary intensity of the economic downturn during the 2008–09 “Great Recession” posed demanding challenges for an appropriate fiscal policy reaction almost globally, not only in advanced economies but also in Central, Eastern and Southeastern Europe (CESEE) – a region where for the first time since the start of transition in the early 1990s the capacities of public finance systems were put under real pressure, even if the starting position in terms of public sector size and level of the government debt ratio was better than in many advanced economies. Theoretically, in such a situation, fiscal policy makers can resort to (1) strong automatic stabilizers, (2) discretionary stimulus packages and (3) favorable borrowing conditions in order to properly cushion the downturn. In reality it is, however, very hard, if not impossible, to rely on all three of these options at the same time, especially in emerging countries with poor fiscal institutions, a lack of trust in the government or an insufficient historical track record for fiscal adjustment. As a consequence, countries might not be able to provide sufficient fiscal support when it is actually most needed. These significant policy limitations were complicated even more by a general shift in mood against the effectiveness of fiscal policy driven by high refinancing needs, rising sovereign risk premia and all sort of spillovers as a consequence of the ongoing crisis.

The notion of fiscal space, as it is used here, captures the capability of fiscal policy makers to properly respond to a business cycle shock.<sup>1</sup> Both sides of the same coin have to be considered in this context: on the one hand, the business cycle stabilization capacities of public finance systems via discretionary measures and free operation of automatic stabilizers; on the other hand, the capacity of public finance systems to remain resilient to a shock, i.e. to avoid a budget or debt crisis because of the shock.

A brief diagnosis of limited fiscal space in the CESEE EU Member States (CESEE-10<sup>2</sup>) contains the following elements:

- First, discretionary fiscal policy was expansionary in most countries of the region in the pre-crisis boom period (basically due to excessive public spending), while during the crisis it was only possible in exceptional cases to implement sizeable stimulus packages (Poland).<sup>3</sup>
- Second, despite the overall lack of fiscal stimuli, fiscal headline positions strongly deteriorated during the crisis (with the very specific exception of Hungary), which can be traced back to a stronger-than-expected revenue erosion (this will be elaborated in more detail in subsequent contributions). At the same time, it should also be noted that during the crisis public deficit and public debt ratios deteriorated, on average, less strongly in the CESEE-10 than in the EU-27 (see chart 1). However, the tolerance threshold for public indebtedness might be lower for emerging economies than for advanced economies.
- Third, financing conditions deteriorated remarkably during the crisis. This is illustrated by the development of CDS premiums for government bonds, which rapidly increased at the end of 2008 and at the beginning of 2009 and, despite some recovery thereafter, are still above the levels observed before the crisis (see chart 2).<sup>4,5</sup> A few countries were accordingly confronted with sovereign

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<sup>1</sup> There are several definitions of fiscal space in the literature, e.g. financing the deficit without either a sharp increase in funding costs or undue crowding out of private investment (see Ostry et al., 2010).

<sup>2</sup> Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

<sup>3</sup> Baldacci et al. (2009) show for a worldwide sample that during systemic banking crises the effectiveness of fiscal expansions (if they were implemented at all) and the quality of fiscal performance were undermined in countries with insufficient fiscal space. This evidence backs the view that countries with limited fiscal space are constrained in using fiscal policy for effective business cycle stabilization.

<sup>4</sup> Darvas (2010) expects that risk premiums in CESEE will remain higher than their pre-crisis levels for a prolonged period as a consequence of the crisis-related rise in overall risk perceptions (“flight to quality”) and unjustifiably low CDS levels before the crisis.

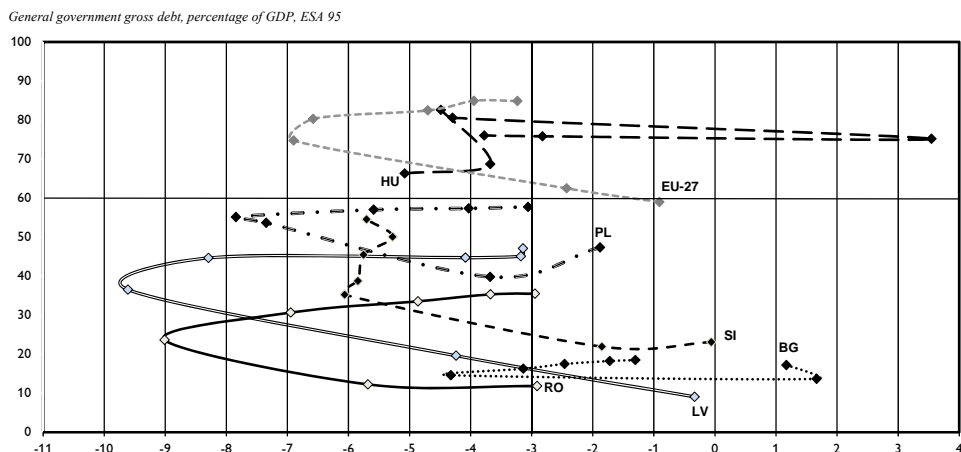
<sup>5</sup> Interestingly, at the beginning of the crisis the sovereign CDS premiums for euro area periphery countries (left panel in chart 2) were considerably lower than those in the

liquidity problems and had to resort to the IMF and the EU for multilateral assistance (Hungary, Latvia, Romania).

Altogether, this brief diagnosis indicates that public finance systems in most of the CESEE-10 have neither been able to appropriately contribute to business cycle stabilization nor to withstand a large business cycle shock, which points to both limited crisis mitigation capacity and limited crisis resilience.

The remainder of this introductory contribution to the overall topic of this workshop is structured as follows. Section 2 elaborates the reasons for limited fiscal space in CESEE. Section 3 outlines fiscal peculiarities of the CESEE countries in comparison to Western Europe and discusses some related implications for euro area enlargement. Finally, section 4 summarizes the policy options to create more fiscal space in the future as discussed in the workshop.

*Chart 1: Development of the General Government Budgets of Selected CESEE EU Member States, 2007–2013*



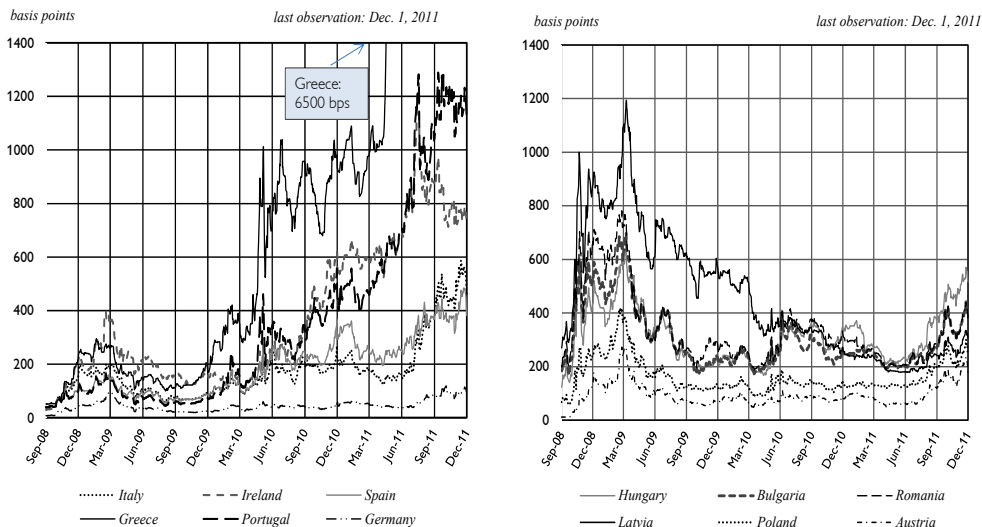
Source: European Commission, AMECO database. 2011–13 data are forecasts as at end-October 2011.

Note: The first observation point (2007) is marked by the country code.

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CESEE EU Member States. This picture has, however, been reversed once several euro area periphery countries were confronted with serious sovereign solvency concerns as from early 2010.

*Chart 2: Credit Default Swap Premiums for Government Bonds with 5-Year Maturity*

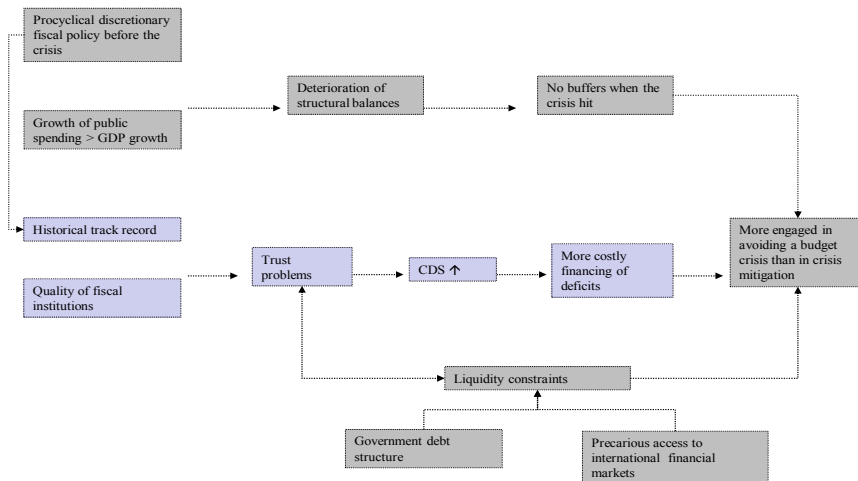


Source: Thomson Reuters, compiled by the OeNB.

## 2. Reasons for Limited Fiscal Space in CESEE

At least three different channels can be distinguished that illustrate why during the crisis most of the CESEE countries had to put more effort into avoiding a budget crisis instead of being able to use fiscal policy for crisis mitigation (see chart 3). These channels are elaborated in this section in detail by providing some diagnostics and referring to related empirical evidence.

Chart 3: Reasons for Limited Fiscal Space in CESEE



## 2.1 Procyclicality

In general, procyclical discretionary fiscal policy before the crisis and growth of public spending that exceeded potential GDP growth led to a deterioration of structural balances, leaving no buffers when the crisis hit the CESEE region. Exceptions to this overall picture are Bulgaria and Estonia, which in the pre-crisis boom period had accumulated fiscal reserves from budgetary surpluses and used them during the crisis for financing increased deficits (with the result that the debt-to-GDP ratio remained fairly low).

Available empirical evidence broadly points to procyclical fiscal policy in the CESEE-10. Kaminsky et al. (2004) and Ilzetzi and Végh (2008) made a case for procyclical government expenditure in developing and emerging market countries during good times. Rahman (2010) elaborated for the CESEE-10 that procyclicality in total government expenditure was driven in the period 1995–2007 primarily by capital outlays, while compensation to employees and social expenditure were rather insensitive to output gaps. Eller (2009) showed that discretionary fiscal easing in boom times was especially pronounced in Romania, the Baltic countries and also in Slovenia. In contrast, Staehr (2010) found that the *overall* budgetary balance had been moderately countercyclical in the CESEE-10 in the period 1999–2008 (stemming primarily from the revenue side).

According to an optimal fiscal policy model developed by Talvi and Végh (2005), the procyclicality of fiscal policy in developing countries is ascribable to large fluctuations of tax bases which lead to abundant fiscal resources during good

times. Given a lack of appropriate fiscal rules and/or institutions, budgetary surpluses are, however, not saved for subsequent bad times but are rather spent immediately due to political pressure. As a consequence, governments in developing countries are unable to generate large-enough surpluses during expansions, which forces them to borrow more during recessions. This reasoning is quite likely also valid for the emerging economies in CESEE. In a similar vein, scholars are arguing that political pressures can lead to expansionary fiscal policies regardless of the cyclical position. For instance, Brender and Drazen (2005) showed that political budget cycles (i.e. pre-electoral fiscal expansion to increase the probability of re-election) are more prevalent in new democracies than in established democracies. As another reason for procyclical fiscal policy, one should consider that fiscal policy decisions might have been based on information that later turned out to have incorrectly indicated the stage of the business cycle. Real-time and ex post output gaps may considerably differ. This holds in particular for emerging economies as they are prone to substantial and frequent shocks.

## **2.2 Historical Track Record and Quality of Fiscal Institutions**

Fiscal space in its policy sense and very much related to policy credibility strongly depends on the historical track record for fiscal adjustment (see Ostry et al., 2010). The comparative period for the CESEE countries is relatively short. Nevertheless, various CESEE countries have consistently failed to meet their structural balance targets before the crisis (partly due to the procyclicality bias discussed above and a lack of qualitative fiscal institutions). As a consequence, trust in fiscal discipline had been undermined and once the crisis hit these economies, CDS spreads and thus the financing costs steeply widened although the debt-to-GDP ratios were still in a comparatively good shape.<sup>6</sup> A strong linkage between failed implementation of fiscal plans and worse fiscal outcomes is revealed by Beetsma et al. (2009) for the EU-15.

## **2.3 Sovereign Liquidity Constraints and Government Debt Structure**

Domestic capital markets in CESEE are still less developed than in advanced countries and, as a consequence, governments in the region tend to and have to borrow more externally and more in foreign currency than advanced economies. At the beginning of the crisis, when CESEE governments had to rely on these external

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<sup>6</sup> This also points to tolerance thresholds for public indebtedness that are lower in emerging economies than in advanced economies. Sturzenegger and Zettelmeyer (2006) highlighted that sovereign debt defaults occurred in several emerging economies at reasonably low debt-to-GDP ratios.

financing sources in order to meet maturing liabilities or roll them over, access to international capital markets became precarious (not least enforced by trust problems) and a few, but not all, governments in CESEE faced serious liquidity constraints. Thus, external funding weakened when it was actually needed most, corroborating the “when it rains, it pours” phenomenon that had been frequently observed in emerging market economies (Kaminsky et al., 2004).<sup>7</sup>

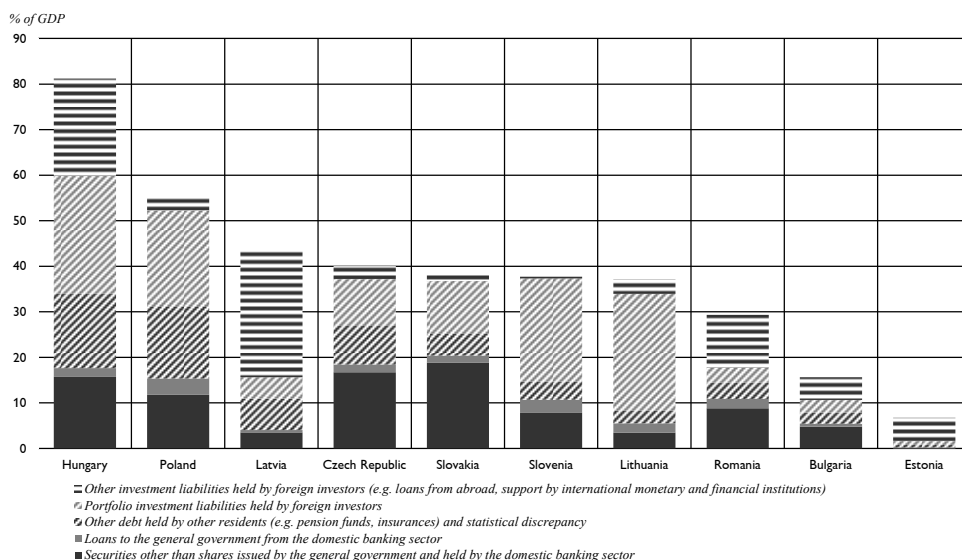
For a respective assessment, a brief description of the structure of government debt in the CESEE-10 is a necessary ingredient<sup>8</sup>, as important cross-country differences have to be considered. The share of government debt *held by nonresidents* (see chart 4) is particularly large in the Baltic countries, with more than 75% of total government debt, but also in Slovenia and Hungary, with about 60%. In the other CESEE-10 countries it ranges between 30% in the Czech Republic and 50% in Romania. Foreign portfolio investors, who are most likely to withdraw their money earlier in bad times than other investors, hold a considerable share of total debt in Lithuania and Slovenia (more than 60%), but also in Hungary and Poland (between 30% and 38%). Throughout the crisis the share of government debt held by nonresidents strongly increased in most CESEE-10 countries, partly due to multilateral support programs (Hungary, Latvia) and partly due to the issuance of euro bonds by state-guaranteed banks (e.g. Slovenia). At the same time, the share of securities (other than shares) held by the domestic banking sector also increased in a few countries (most notably in the Czech Republic, Slovakia and Romania), pointing to improved domestic absorbance capacities there.

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<sup>7</sup> In contrast to earlier crises and the evidence provided by Kaminsky et al. (2004), countries in CESEE did *not* experience large-scale capital outflows during the Great Recession, which can be attributed, among others, to the so-called *Vienna Initiative* that was launched at the height of the financial crisis to provide a framework for coordinating the crisis management and crisis resolution of financial sector issues (see Nitsche, 2010, and <http://www.ebrd.com/downloads/research/factsheets/viennainitiative.pdf>).

<sup>8</sup> Reported data refer to the consolidated general government gross debt and were collected by the OeNB from Eurostat, the IMF and national central banks.

Chart 4: Structure of Government Debt by Holder (End of Q3 10)



Source: Eurostat, IMF, national central banks.

Note: Whole bar represents consolidated general government gross debt as % of GDP.

Besides the holder structure, also the *currency structure* of government debt is important for liquidity assessments. If the share of government debt denominated in foreign currency is high and the country has a flexible exchange rate arrangement, a depreciation of the domestic currency, which typically can be observed during a downturn, increases the debt-to-GDP ratio and the debt servicing costs. Thus, the most vulnerable countries are those with a flexible exchange rate system and a high share of foreign currency-denominated debt. Based on the currency composition of debt as at the end of 2009, this is mostly an issue for Romania, with a foreign currency share in total general government gross debt of about 60%, while this share is comparatively small in other CESEE-10 countries with flexible exchange rate systems: it stands at 16% in the Czech Republic, at about 30% in Poland and at about 40% in Hungary. Government debt in the remaining CESEE-10 countries is to a major extent denominated in euro. For a few of them – the euro area countries Slovakia, Slovenia and Estonia – it is by now already denominated in their domestic currency; for the others – Bulgaria, Latvia and Lithuania with their fixed exchange rate pegs vis-à-vis the euro – it is still denominated in foreign currency.

Regardless of the currency composition of government debt, if its *maturity* is biased toward the short term, interest rate movements have a substantial impact on debt servicing costs. An increase in interest rates – which is very likely in emerging



markets during downturns because of higher risk premiums – in the case of sizable short-term debt immediately translates into a higher servicing burden and thus limits fiscal space. Based on the maturity structure of total general government debt as at the end of 2009, in most CESEE-10 countries, maturities of less than one year account not for more than 7% of total maturities. Exceptions are Romania, Latvia and Hungary with a corresponding share of 23%, 15% and 11%, respectively.

Altogether, while the currency and maturity structure of government debt, with a few exceptions, is rather favorable in the CESEE-10, the share of domestic holders is still comparatively low and has in several cases even decreased throughout the crisis. Moreover, in several countries, foreign portfolio investors hold a sizeable share of government debt. This has to be seen in the context also that a significant consequence related to the recent crisis experience is a certain change in mood in this respect: Has a high share of foreign debt holders be seen as an advantage before the crisis, revealing the country's attractiveness to foreign investors, nowadays this is qualified as a certain disadvantage due to the potential volatility of this type of investment. A key solution to this mismatch seems to be the strengthening of domestic capital markets (see also section 4).

Finally it should be noted that all the three different channels presented in this section are obviously also interrelated. For instance, a lack of trust in fiscal institutions exacerbates external borrowing constraints during recessions. Sovereign liquidity problems, in turn, undermine the trust in fiscal sustainability and translate into higher risk premiums. Furthermore, a long track record of procyclical discretionary fiscal policy raises concerns about the quality of fiscal institutions, reduces the debt tolerance threshold for these countries and thus increases borrowing costs during recessions. This constellation requires fiscal tightening during downturns and thus further aggravates the procyclicality bias.

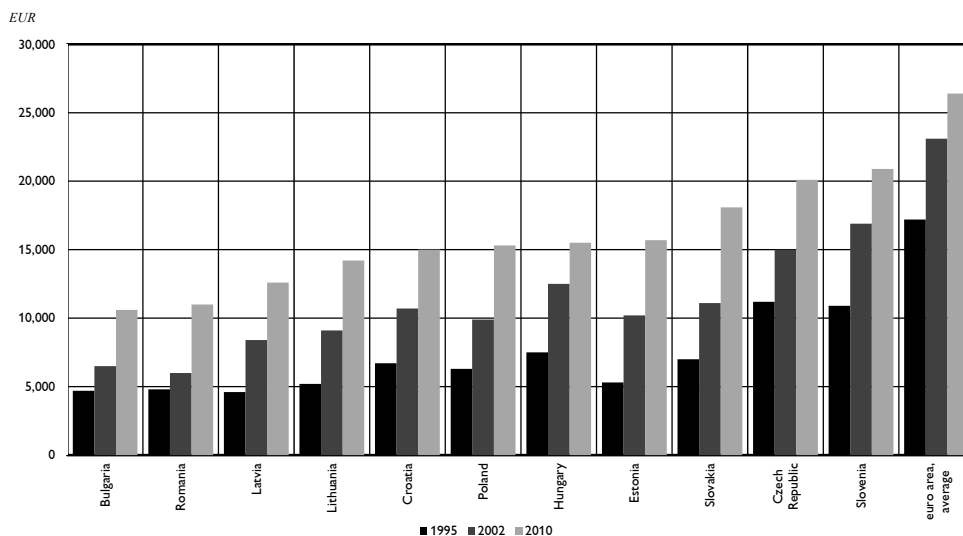
### **3. How Different Are CESEE Countries as Far as Fiscal Needs Are Concerned?**

#### **3.1 Some Fiscal Peculiarities of CESEE Countries**

Most of the ongoing fiscal debate in CESEE is very similar to the one faced in Western EU countries. In both regions there is broad agreement that consolidation has first priority because of the impact the crisis had on budgets and because of the higher market sensitivity regarding refinancing needs. This is not surprising as economic policy sets – via the Stability and Growth Pact and, more recently, via the EU scoreboard for the surveillance of macroeconomic imbalances – exactly the same benchmarks. In the same vein, equal measures are suggested, and, as a result, the same pros and cons are widely debated. For instance, should the consolidation process be more revenue or more expenditure driven? Should the consolidation

process go along with some redistribution? How far does consolidation endanger growth? From a bird's-eye view this homogeneous approach raises the question "Does one size really fit all"?

*Chart 5: Real GDP per Capita in Purchasing Power Parities*

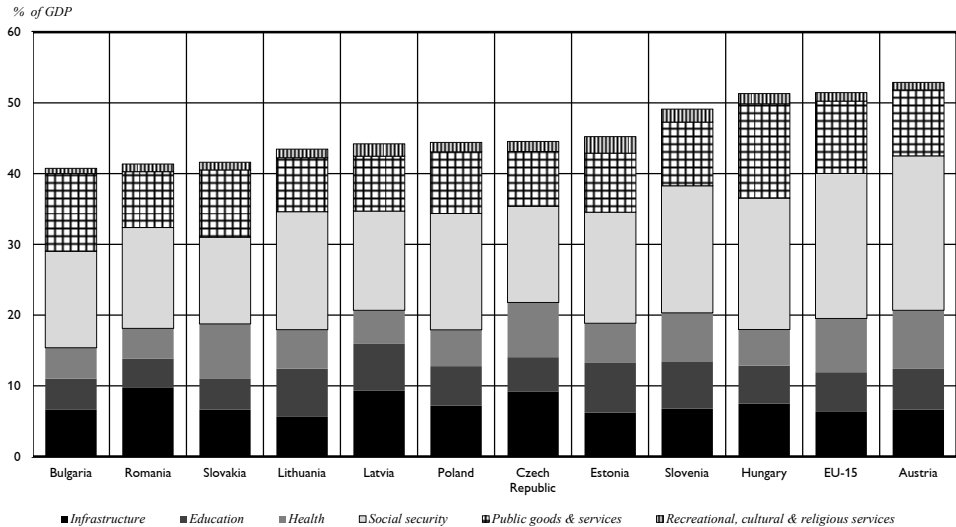


Source: Eurostat, European Commission's AMECO database, wiiw.

Obviously, more or less the same framework of economic thinking, but also institutional rules and guidelines, are applied. As a result, economic peculiarities of CESEE countries are not taken into account, although relevant economic differences are still huge even from a macroeconomic point of view. On the one hand, Western EU countries are highly developed, GDP per capita is above average (see chart 5) and markets of all kinds are quite deep. On the other hand, emerging European countries still undergo a significant catching-up process. The EU fiscal framework applies the same rules to all of them, raising the question that there may be special needs which should be taken into account by fiscal policy. Fiscal needs can be located in several fields:

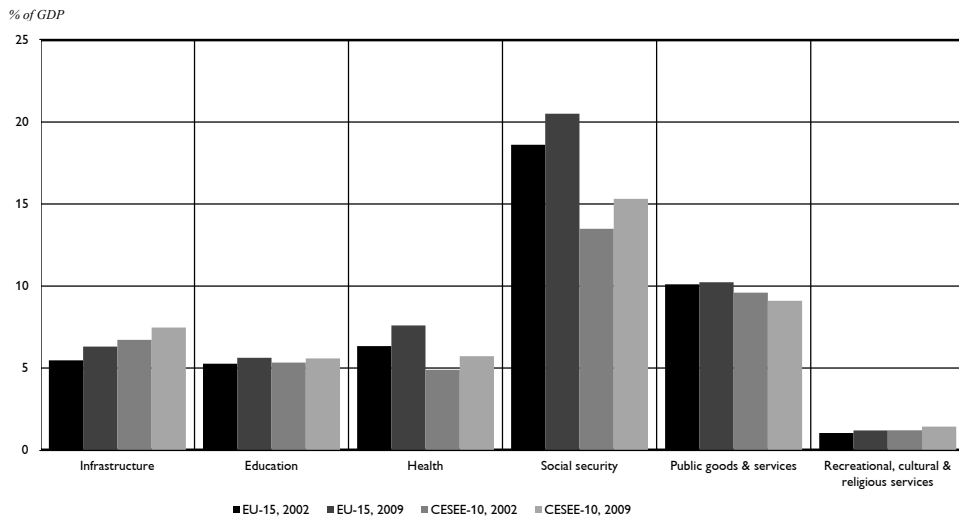
General government expenditures as a percentage of GDP are (slightly or significantly) lower in the CESEE EU Member States than in the EU-15 (see chart 6), reflecting the transformation period in which the public budget had played only a minor role as institutions were nonexistent and tasks had to be newly defined. This is also one of the reasons why fiscal stabilizers are not as developed in CESEE as in Western EU countries (see Eller, 2009), which contributes to relatively volatile real GDP growth.

*Chart 6: General Government Expenditures as % of GDP by Functional Classification, 2009*



Source: Eurostat.

*Chart 7: General Government Expenditures by Functional Classification: EU-15 versus CESEE-10, 2002 and 2009*

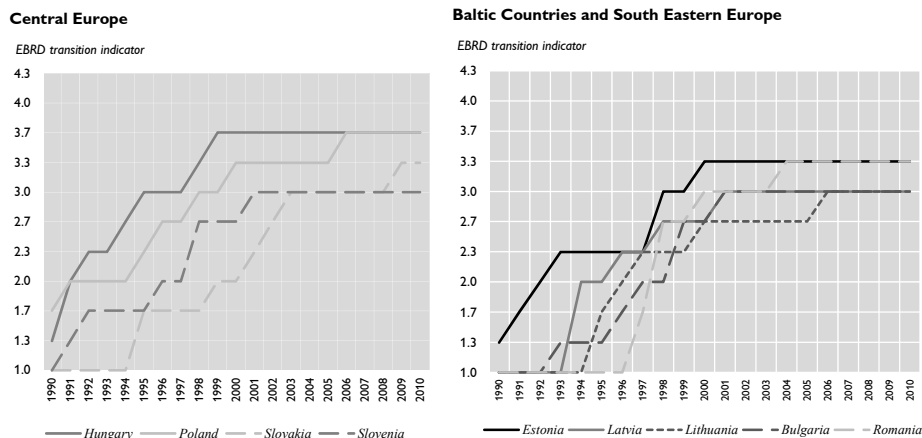


Source: Eurostat.

Note: Unweighted averages are reported.

While government expenditures for public infrastructure have steadily increased and show a larger share of GDP in the CESEE-10 compared to the EU-15 (see charts 6 and 7), the overall supply of infrastructure obviously still lags behind Western European standards. The European Bank for Reconstruction and Development (EBRD) regularly publishes a public infrastructure reform indicator: Although public infrastructure improved significantly in the 1990s, the last decade rather attests to a standstill in this respect (see chart 8). At the same time, the demand for new and for deepening existing infrastructure projects – e.g. in the context of Trans-European Networks – remains at a high level. This is illustrated by the fact that the European Investment Bank (EIB) nearly doubled its annual lending to the CESEE EU Member States from EUR 6 billion in 2007 to EUR 11 billion until 2009, of which a major part (40%–50%) consists of financing large-scale infrastructure projects. Programs of the EIB or the EBRD have the precondition that the country finances at least part of the project itself. The same is also true for structural funds from the EU, which play a significant role in CESEE; however, their financing share is limited to 85% of the total investment costs, so whenever Brussels supports a project, the national budget also has to contribute. If this mechanism is subject to stringent consolidation rules, one of the major instruments to support the catching-up process (and implicitly convergence between EU member countries) no longer works.

*Chart 8: Overall Infrastructure Progress in CESEE*



Source: EBRD (2010).

Note: The indicator is the average of five infrastructure indicators, covering electric power, railways, roads, telecommunications, water and waste water; ranked from 1 (little progress in commercialization and regulation, minimal private sector involvement) to 4.33 (fully autonomous regulator exists with complete authority to review and enforce tariff levels and quality standards). Data for the Czech Republic are not available (not an EBRD country of operation since 2007).

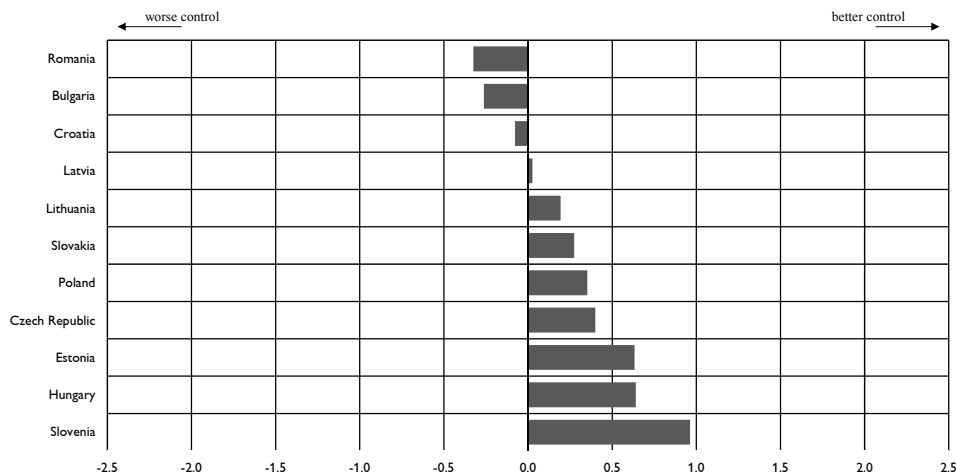
Another possibility of financing infrastructure projects is that the private sector steps in. But this possibility is quite limited for several reasons. First, competition for FDI has become fierce recently. As other emerging market regions have been growing at an incredibly fast pace, especially China, but also Latin America, some investors have left the CESEE region, opting for more promising markets. Second, the financial market crisis has made investors more hesitant, as they take increased risk premiums, but also reduced lending opportunities into account. Banks, deleveraging at home but also in the region, are putting on additional breaks. Although growth rates of lending had been more or less excessive before the crisis, and lower ones are definitely welcomed, several projects, especially small and medium ones, will not be financed any longer. Third, many infrastructure projects have a limited possibility for earnings. Therefore public private partnerships (PPPs) have their merits, but overall this concept is limited by nature to a relatively small number of projects (e.g. highways, public transport).

Fiscal policy instruments and their effective implementation differ quite a lot. In general, tax systems in CESEE are less sophisticated (diversified), as income, wealth and land registers sometimes started from scratch and have yet to function fully. Some kinds of taxes do not exist at all, or are not widespread, or the tax structure as a whole is different. Flat rate tax systems are much more popular in CESEE compared to Western Europe, as domestic (re)distributional aims are perhaps valued less important. Instead, public finance systems in CESEE offer incentives for both domestic investors (e.g. via favorable corporate tax rate structures) and foreign investors (e.g. via subsidies for FDI). There is only rare evidence in the literature that fiscal multipliers in emerging Europe differ systematically from those in advanced Europe (see Eller, 2009). However, there are several reasons to expect that the economic transmission channels, to which the mentioned fiscal instruments are applied to, work differently. For instance, households and private-sector firms may react differently, especially as social security systems in CESEE are less developed and far fewer government expenditures are earmarked for this kind of purpose (see charts 6 and 7). These different approaches to social security systems trigger different consumption, investment and, naturally, savings behavior. In addition, a relatively large shadow economy, fiscal circumvention or fraud may not only reduce tax revenues, but also the overall efficiency of fiscal measures.

Corruption, regularly monitored by the World Bank (see chart 9), as well as fighting corruption has a strong fiscal link. Quite often it is forgotten that an improvement in fighting corruption is not only the result of political willingness, or – more economically – the result of reducing social inequality and income differentials. Low corruption is also the result of fiscal spending. Institution-building is costly, not only in terms of facilities, but also in terms of education and building up knowledge. Without qualified civil servants who are able to detect,

fight and finally prevent corruption, a sound basis for successful institution-building and long-term sustainable growth rates is lacking.

*Chart 9: Control of Corruption in CESEE*



Source: World Bank.

Note: Control of corruption represents the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests. Range: -2.5 to +2.5. Higher values correspond to better governance outcomes.

Expectations of the local population regarding the speed of the catching-up process are high. Western politicians and economists ask CESEE countries for more patience, as rebuilding of many Western economies after World War II took several decades. But the situation is hardly comparable. Complete information about the alternatives, as presented by the world-wide web, in combination with a consumption-oriented society enhances expectations. In the last decade high credit growth rates enabled households to increase their personal standards of living relatively quickly, which led to similar expectations concerning the modernization of the infrastructure and the public environment. Politicians have a hard time coping with these very high expectations, which leads to short-lived governments and frequent political changes. As a result, consolidation in good times, which, by the way, did not function in Western Europe either, did not function in CESEE at all. The best-known example is Hungary, which still suffers from running an over-expansionary budget before the crisis.

### **3.2 Theoretical Needs and Practical Possibilities**

It is of particular importance that the catching-up process of the region does not come to a halt neither in general nor in specific countries. A further prosperous development of emerging Europe is not only crucial for its own well-being, but also has significant implications for their meagerly growing neighbors, in particular the euro area countries. Besides that, growth and property are key for political and social stability in emerging Europe. One should not forget that the whole region underwent a regime shift only twenty years ago, and although the political landscape has changed completely and the development seems to be irreversible, social unrest, becoming visible in chasing minorities, is not totally unlikely.

In this respect we should always keep in mind to which extent fiscal measures have so far supported this catching-up process, and what are the risks for economic growth and political stability if fiscal measures cannot be used any longer at all because of very strict consolidation efforts. This is not a plea against consolidation, but one should look for a more differentiated fiscal approach which takes into account the special needs of the region. No country easily runs a fiscal consolidation process. But for a transition country it is even more complicated, so as not to damage fundamental economic growth prospects nor interrupt the catching-up. The transition process does not only consist of an above-average GDP growth rate. It also goes hand in hand with structural and institutional fundamental changes triggered by fiscal measures. Sustainable fiscal consolidation should take these needs into account.

### **3.3 Implications for Euro Area Enlargement**

For the moment a further euro area enlargement is not part of the agenda. Slovenia, Slovakia and Estonia, which introduced the euro recently, will not be followed by another CESEE country soon. Major disruptions in the euro area itself, but also quite successful experiences in weathering the crisis without the euro (see e.g. Poland in 2009 and 2010) have led to a postponement of euro introduction plans. Regardless of these decisions, non-euro area countries are facing the same fiscal rules. In addition, they are also facing the same reactions of the financial markets. Although many countries still enjoy relatively low debt ratios, financial markets are sensitive to increasing budget deficits, data revisions, tensions in the money market, devaluations of the exchange rates, unsustainable credit growth rates, and high foreign currency credit shares. These financial market sensitivities and reactions are definitely an additional argument for a prudent fiscal policy. But as in other periphery countries one should not forget about necessary growth, which is more difficult to enhance in an environment where the private sector has been established only recently, and where international investors are as mobile as the labor force, checking out more rewarding investment opportunities every day.

## 4. Policy Options

What are the main policy options to be discussed with a view to create more fiscal space in the CESEE countries in the future?

First of all, *reforms of fiscal governance and implementation of appropriate fiscal rules* have to be referred to as the first-best solution. In particular, it is important to apply adequate expenditure ceilings in order to contain government spending during good times. Expenditure growth should be kept in line with cautious estimates of potential GDP growth. To allow for fiscal space, excess revenue during boom times should be saved and used during the next economic downturn (see Talvi and Végh, 2005). Besides numerical fiscal rules, it is also important to improve the quality of fiscal institutions by enforceable and transparent multi-year rules and by independent fiscal councils which provide regular assessments to decrease information asymmetries between fiscal policy makers and the public (see Darvas, 2010, and Ódor, 2011). Beetsma et al. (2009) showed that both planned budgetary adjustment and adherence to these plans are positively related to a strong medium-term budgetary framework and tight numerical fiscal rules. As a result, fiscal discipline should be enhanced and trust in fiscal policy making be endorsed, which, in turn, should keep borrowing costs during recessions in check. Iara and Wolff (2010) provide respective evidence for eleven euro area countries: stronger fiscal rules contain sovereign bond spreads, particularly in times of elevated market uncertainty and if the rules have a strong legal foundation. While the beneficial effects of fiscal rules are acknowledged, it is also important to monitor their impact on the composition of public spending. During episodes of rule-enforced fiscal adjustment, politicians may have an incentive to abandon long-term investment projects instead of cutting current outlays. Pitlik (2010) found for the EU-15 that government investment has indeed been limited by stringent quantitative fiscal constraints.

*Sovereign liquidity constraints* during recessions cannot be *mitigated* by appropriate fiscal rules alone. Equally important is an improvement of the liabilities' composition in the public sector balance sheet (see Baldacci et al., 2009). To reduce vulnerabilities, government debt should be redirected to domestic holders, longer-term maturities and domestic currency denomination (the latter is especially important for countries with a flexible exchange rate system). The strengthening of domestic currency capital markets is crucial in this context. Another policy option would be the implementation of suitable financial market instruments which help governments in adjusting their cash flows in line with the business cycle. One example are GDP-indexed bonds as proposed by Borensztein and Mauro (2004), whereby interest payments on government bonds are reduced in bad times and increased in good times. This forms a kind of insurance against economic slowdowns and should help to strengthen the countercyclical pattern of fiscal policy. However, implementing this instrument means that the respective



business cycle position has to be identified in real time, which is very difficult in emerging economies, given pronounced macroeconomic volatilities. Moreover, the demand reaction is unclear *ex ante*; it might be rather difficult to place GDP-indexed bonds with longer-term maturity.

Staeher (see the contribution in this conference volume) presents a concrete policy option in proposing to *use funded pensions actively as a countercyclical instrument*, thereby enhancing the crisis resilience and stabilization capacity of public finance systems in CESEE. This could be done by allowing for lower contributions and/or withdrawals of accumulated pension savings during bad times and by taxing released pensions in such a way that burdens on public budgets can be reduced in a recession. The ensuing discussion in the workshop revealed that it is important to consider the asset composition of funded pensions as, e.g., the price of stocks behaves procyclically and, therefore, withdrawals of pension savings during bad times can amplify price declines and increase systemic risk. The design of appropriate incentives for rebuilding savings during good times is equally important.

Clearly, the application of these policy options has to account for a considerable degree of heterogeneity within the CESEE region that was also revealed during this crisis – not only in terms of macroeconomic outcomes, but also in terms of fiscal responses (for instructive country groupings, see Staeher, 2010, or the contribution of Neven Mates in this conference volume). Moreover, it is also important to account for peculiarities in CESEE which are different from those in Western Europe. Politically they are members of the same union; economically the CESEE countries are still in a catching-up process, facing different goals, certain needs and particular constraints.

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