The Impact of the Crisis on Budget Policy in Central and Eastern Europe

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CESEE Countries have been severely hit

GDP growth from 2007 to 2010 as seen in October 2007 and April 2009

Comprehensive chart showing the cumulative change in GDP from 2007 to 2010 as seen in October 2007, April 2009, and the change in GDP level forecast for 2010 from October 2007 to April 2009, for various countries.
Outline

1. Why CESEE countries were the hardest hit among emerging/developing regions?

2. The Impact of the Crisis on Budget Policy: Main channels

3. Budget policy reactions in CESEE countries

4. Lessons from previous emerging market crises to budget policy

5. Budget policy options in CESEE countries
1. Why CESEE countries were the hardest hit among emerging/developing regions?

- **Two key issues:**
  1. Capital flows and financial integration
  2. Trade integration

- **And two others:**
  3. Migration and remittances

E.g. remittances are very important for some countries: Moldova (34% of GDP in 2007), Bosnia/Herzegovina (17%), Armenia (14%), Albania (13%), Georgia (7%), Bulgaria & Romania (5%), and between 2 and 4% for eight further countries

4. Institutional development and strength
The CESEE region was different

GDP growth and the current account, 2003-2007

26 CESEE countries  152 other countries of the world

- Negative correlation is in CESEE (except some commodity-exporters)
- Positive correlation in other developing and emerging countries
Why the sign of correlation between CA and growth differs?

- **Negative correlation in non-commodity rich CESEE countries:**
  - Relaxation of previous constrains in access to foreign capital → capital inflows, consumption, investment, CA deficit → negative correlation (see also some additional factors on credit growth later)
  - Productivity shock → higher income expectations → textbook intertemporal optimization

- **Positive correlation in developing countries** (e.g. Prasad et al 2006, Colins 2006)
  - Demographic shift to reduce dependency, increases in population in the labour force → increase in saving and output → positive correlation between CA and growth
  - Productivity shock → higher income, but financial impediments limit investment and consumption → positive correlation
  - Policy shift to export promotion (e.g. avoiding overvaluation)

- **Should capital inflows dwindle in the medium/longer term as well and capital become more expensive, how to adjust in CESEE** when real exchange rate devaluation (in most countries) is not a real option (in contrast to Asia 1998/98)?
Parallel with capital inflows: strong credit booms in many CESEE countries

Credit to private sector (% GDP), 1995-2007
Key question for credit growth: role of the budget then and now

- Credit boom was mainly related to the private sector
- Government debt was generally low in the region
- Budget deficit varied, fiscal policy was pro-cyclical in many countries, but in general the budget was not a serious problem (apart from some outliers like Hungary)
- Asymmetry: it was the private sector that took most of the debt, but the public sector has to take up the mess now (cf. Latvia’s heroic efforts to cut the budget deficit when GDP falls about 15% in a single year)
- This asymmetry is similar to the failure of the Stability and Growth Pact (with its narrow focus on budgets) to preserve euro area’s stability
- Strengthening regulation and supervision, as well as institutions for anti-cyclical budget policies are inevitable
General government gross debt (% GDP): generally low with some exceptions

Note: countries are ordered according to their 2007 debt level.

Note: 2010 forecasts (DG ECFIN, May 2009) are available only for EU countries.
Cost of insurance against government default: sharp rises indicate lack of confidence

Credit default swap on 5-year government bonds
2 January 2008 – 15 June 2009
Why such a large government default risk? (When government debt is generally low)

- The most likely reason is the risk inherent in private sector debt in many countries, which is (in some countries) mostly in euros or dollars.

- The magnitude of the bank losses to be assumed is still highly uncertain; in countries with high foreign bank participation burden sharing is an issue (Vienna Initiative aims to handle burden sharing).

- Should the economic outlook deteriorate further, and/or exchange rate collapse (e.g. Baltics), or fall further (e.g. Ukraine, Hungary): even deeper crisis, more bankruptcies, unmanageable losses of banks, complete dry up of foreign capital → may end in a government default as well.

- Indeed, rising government default risk is related to the current account and external indebtedness after the crisis, not before (see next chart).
Cost of insurance against government default is related to external debt (net foreign loan and debt liabilities)
When and **by how much** will capital inflows resume?

*What to learn from previous crisis episodes regarding capital flows?*

- Maybe the time profile in the aftermath of crises
- No clue on expected future magnitudes
  - Note: all past crises were followed by even larger flows some years later
  - But: current crisis is different as it is a global one and deleveraging/more regulation/less global liquidity will limit future flows
  - Also, many, but not all CESEE countries are highly integrated to the EU15 (banks, corporations)
  - How will Western European banks behave in the medium term regarding credit expansion to the East?
- Bottom line: CESEE countries have to prepare for a lasting reduction in capital flows and higher risk premia
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2. The Impact of the Crisis on Budget Policy: Main channels 1.

- **Direct fiscal impact**
  - Declining revenues
  - Automatic stabilizers
  - Discretionary fiscal stimulus
  - Fiscal support for the financial sector
2. The Impact of the Crisis on Budget Policy: Main channels, 2.

- **Changes in the global economic environment**
  - Less capital inflows and even outflows, deleveraging, reduction in global liquidity: constrains on raising capital
  - Rising risk premia, higher cost of capital
  - Impact through trade and migration
  - Major economies: huge budget deficits and rises in government debt → prolonged adjustment there affects CESEE
2. The Impact of the Crisis on Budget Policy: Main channels, 3.

- **Reconsideration of medium/long term outlook**
  - Growth prospect: previous „growth model” at risk + possibility of a prolonged world recession/stagnation
  - Negative wealth effects (pension funds; equity prices; housing prices; commodity prices; the effect of interest rate and exchange rate changes on debt)
  - Fiscal sustainability
  - Pension and healthcare
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Budget deficits: rather diverse outcomes (% GDP)

Note: Azerbaijan had a 25.5% budget surplus in 2008, but for better readability of the chart the vertical axis has a 9% cut-off.
3. Budget policy reactions in CESEE countries

- Budget policy reactions can be understood only in a broader context of other macroeconomic policies and constraints/possibilities.

- Some countries face serious financial and confidence constraints:
  - E.g. IMF programs: stand-by for 7 countries and talks with 2 others; Flexible credit line (Poland); poverty reduction for some.

- On the other hand, Russia, a large and not so open economy with huge fiscal reserves (and gross government debt below 10% of GDP) has scope for fiscal stimulus: the largest stimulus among G-20 in 2009 and the 6th considering the 3 years from 2008 to 2010.

- So far direct budgetary support for the financial sector was generally low or zero in CESEE countries: no US-related toxic assets, but domestic losses increase NPL.

- International support for the banking system in CESEE (joint IFI initiative of €24.5 billion in two years; “Vienna Initiative”; Western bank ownership and EU commitments).
<table>
<thead>
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<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>All three years</th>
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<td>3.5</td>
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<td>2.1</td>
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<tr>
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<td>4.9</td>
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### IMF: Headline Support for the Financial Sector and Upfront Financing Need (As of May 19, 2009; in percent of 2008 GDP)

<table>
<thead>
<tr>
<th></th>
<th>Capital Injection</th>
<th>Purchase of Assets and Lending by Treasury</th>
<th>Central Bank Support Provided with Treasury Backing</th>
<th>Liquidity Provision and Other Support by Central Bank</th>
<th>Guarantees (excluding deposit insurance)</th>
<th>Total</th>
<th>Upfront government financing</th>
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<tr>
<td>Russia</td>
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<td>Turkey</td>
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</table>
3. Budget policy reactions in CESEE countries

INVITATION TO THE PARTICIPANTS OF THIS CONFERENCE

The paper includes a table in which we tried to collect the various fiscal measures taken by all 26 CESEE countries in response to the crisis. Comments are welcome.
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4. Lessons from previous emerging market crises to budget policy

- Debt crises, currency crises and banking crises provided major impulses to structural reforms in general and of the budget in particular
- CESEE countries provide many examples as well
- Let me highlight two cases: Russia and Brazil after 1998
4. Russia 1998

- Russia’s fiscal policy was characterized by very high deficits before the 1998 crisis (9% between 1994-97). Business subsidies amounted to about 16% of GDP with little social benefit
- 1998: default; no bail-out by the IMF
- Financing constrains forced vital fiscal reforms
  - Cut in public expenditures by 14% of GDP from 1997 to 2000
  - Many inefficient subsidies were abolished levelling the playing field
  - Centralization of revenues away from the regions to the central government
  - Monetization, rollback of barter
  - Continued tax war on oligarchs
  - New aggressive bankruptcy law strengthened budget constrains
- Later (2001/2002) radical tax reform, measures to improve the ease of doing business, security of property rights, privatization of agricultural land
4. Brazil 1998/1999

- Brazil’s economic history since the oil shocks was about crises, instability, hyperinflation, temporary economic booms followed by serious busts, and serious fiscal tensions between the central and regional governments.

- June 2009: Instead of calling in the IMF, Brazil intends to invest US$10 billion in notes to be issued by the IMF to support the Fund’s activities elsewhere.

- What happened after 1998/99?

  - Very ambitious fiscal reform started in 1998.
  - Primary balance target (3.75%/GDP initially, then 4.25%).
  - Cutback of FX liabilities.
  - Strict monetary policy with inflation targeting under floating exchange rate.

  - Strong growth; Brazil weathers the current storm rather well.
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5. Policy options in CESEE countries, 1.

- In principle the current global economic environment calls for Keynesian policies.
- Further, government debt is generally low in many (but not all) CESEE countries.
- Viability of such policies depends:
  - financial constraints, the level of government debt/fiscal reserves, contingent liabilities
  - whether a country is large and closed or small and open
  - strength and credibility of fiscal institutions
  - potential risks to investors’ confidence
  - potential of crowding out private investment
Source: World Bank. Note: the average score of all countries of the world is zero.
5. Policy options in CESEE countries, 2.

- „Good” crisis or „bad” crisis? Many previous crisis episodes induced substantial fiscal reforms including serious budget cuts (despite previous arguments for the impossibility of breaking interest groups and reducing public expenditures)

- External financial constrains, while costly in the short run, help to recognize weaknesses of fiscal institutions and prompt reforms leading to much better macroeconomic outcomes

- Still, there are limits and highly pro-cyclical budget cuts during a severe recession should be avoided. E.g. the EU should be more flexible with the Baltic aspirations to join the euro area.
5. Policy options in CESEE countries, 3.

Some general principles:

- Need to keep the financial system working
- The crisis should be used as an opportunity: Structural reforms to enhance growth in general and fiscal frameworks in particular
- Reforms to avoid future pro-cyclical policies and increase credibility (e.g. Medium-term fiscal frameworks, fiscal rules, independent fiscal councils, fiscal responsibility laws)
- Protection of the most vulnerable should be given priority
- Healthcare and pension reforms, especially in countries facing serious demographic pressures
- Spending on pro-growth policies, such as education and innovation, should be preserved, but rationalized
- Fiscal sustainability
Thank you for your attention

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