

## Let's Not Take our Eyes off Fiscal Policy in Eastern Europe

Much has been written about external imbalances, currency mismatches and credit growth in Eastern Europe. This is the dog that didn't bite during the recent market turmoil. Maybe the markets chose to ignore these vulnerabilities because the news from the fiscal front, long considered the Achilles heel of the region, are so good. Are they really?

On the face of it, public finances indeed seem to be in a much better shape than just a few years ago. Most new EU member states are set to overperform their 2007 budget targets on the back of strong revenue growth. Poland and Slovakia now have a good chance to exit the EU's excessive deficit procedure. The authorities in Hungary and, to a lesser extent, in the Czech Republic, have launched ambitious reforms to get their fiscal house in order. Budgets in the Baltics and Bulgaria have never been much of a worry.

But have these countries really done enough to utilize the cyclical upswing? In deciding what fiscal policy should deliver at this juncture, I think one needs to distinguish between the inflation-targeting countries in Central Europe and the fixed exchange rate countries in the Baltics and Bulgaria.

- For the first group, the challenge is to reduce public debt levels in the face of vulnerabilities to shocks and, in the long term, adverse demographics. They also tend to have larger and more inefficient government sectors which are in obvious need of trimming.
- For the latter group, the immediate priority is to cool down their overheating economies in the face of large current account deficits. Chapter 3 of the IMF's October 2007 [World Economic Outlook](#), based on a study of capital inflow episodes over the last two decades, concluded that public spending restraint is the single best instrument to counter excessive real exchange rate appreciation and to ensure better post-inflow growth performance; this is all the more true in countries that have no independent monetary policy.

Upon closer inspection, neither group has done particularly well in using fiscal policy to address these most pressing challenges<sup>1</sup>.

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<sup>1</sup> The correct way to assess the stance of fiscal policy is of course to look at structural balances. This is notoriously difficult, given the methodological problems of calculating potential GDP levels, especially on a comparable basis across countries. The European Commission, in its Spring forecast, estimated that between 2005 and 2007 cyclically adjusted budget deficits deteriorated in Slovakia, Czech Republic and Romania, and remain high in Hungary, Czech Republic, Poland and Romania.

- In Central Europe, public debt/GDP levels have more or less remained flat, despite a strong increase in nominal GDP, nominal appreciation (which reduces the domestic currency value of foreign currency debt), and extraordinary low borrowing spreads. Debt in Poland and Hungary remains above 40-45 percent of GDP, the maximum level that I would consider prudent given the volatility of their revenues and expenditures. Debt sustainability analysis by the IMF and others shows that they remain vulnerable to a variety of shocks. The size of government, measured by the ratio of primary spending to GDP, by far exceeds the levels in other emerging market countries (Chart 1). But where there has been fiscal adjustment, like in Hungary, it has primarily relied in the revenue side.
- In the Baltics, fiscal policy, rather than withdrawing stimulus, has in fact been adding to it. In most new member states of the EU this is being exacerbated by the additional demand stimulus induced by the net inflow of EU funds. As we have shown in a recent paper ([Rosenberg and Sierhej, 2007](#)), these transfers from Brussels not only complicate fiscal adjustment (due to countries' reluctance to make room for cofinancing by reducing spending elsewhere), they also imply an additional demand impulse of some 1-2 percent of GDP under the EU's new 2008-13 financial perspective.

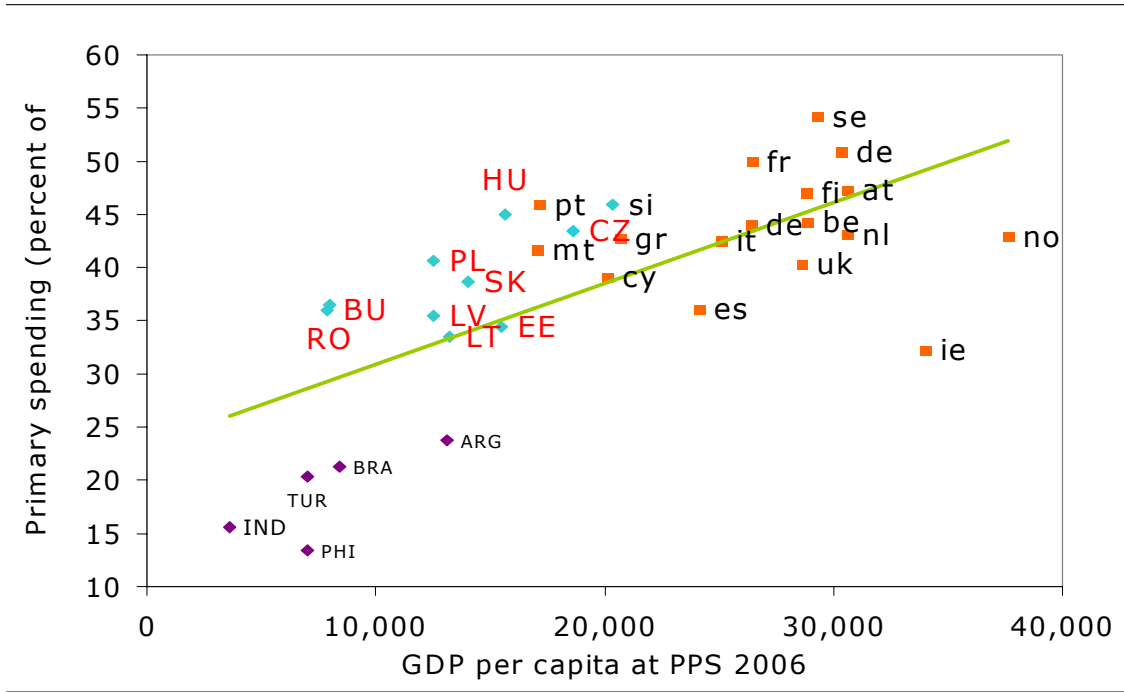
Opportunities may have been missed, but it is not too late to make the necessary changes in fiscal policy. Policymakers don't have to look far for examples how this can be done. Successful earlier adjustment episodes in the region, in Slovakia and previously in the Baltics have two things in common: they relied heavily on reducing real expenditures and they entailed a shift from direct to indirect taxes.

By this standard, the Czech government is doing the right thing by shifting the tax burden from labor and capital to consumption, although its fiscal package still lacks meaningful spending measures. It is also promising that the new Polish government is talking about a new fiscal rule that would limit the growth of spending below that of nominal GDP. Latvia, the Baltic country with the largest imbalances, are signaling a new commitment to fiscal restraint in its 2008 budgets and, like in Estonia, there are now signs that the economy is starting to cool. Ironically, the overheating itself may be helping: labor and construction material appears to be so scarce, that the absorption of EU funds and its associated extra stimulus have lately slowed down.

Even if these plans turn out to be truly good news, it would be unwise to take one's eyes off fiscal policies in Eastern Europe. True, they are no magic bullet. But they are nevertheless the key to whether the region succeeds in making real convergence a smooth or a very bumpy ride.

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Chart 1. Primary Expenditure, 2000-06 average



Source: AMECO, Romania and Bulgaria data for 2005.