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Fiscal Consolidation in the EU's New Member States

By Daniel Daianu

Deep economic and political integration has been seen as the principal way to achieve convergence in Europe. This policy approach has brought about enormous benefits to the European Union's (EU) new member states of Central and Eastern Europe (NMSs), but it has also created vulnerabilities[1]. In particular, the freezing of financial markets played a key role in NMSs' economic downturn. Even countries which were quite fiscally prudent and limited their external disequilibria (i.e. the Czech Republic, Poland) were caught in the economic maelstrom. Financial integration favored bubbles and a significant portion of investment went into the non-tradable goods sectors, especially in the Baltic states, Bulgaria and Romania. As elsewhere in the EU, inadequate regulatory and supervisory arrangements have operated against the backdrop of massive cross-border financial flows and the dominance of foreign banks across local markets. The sovereign debt crisis demonstrates that the size of public debt may not be indicative of the true need for fiscal consolidation. How to achieve this consolidation without getting into vicious circles is less clear. This is why, in NMSs EU structural and cohesion funds have an additional strategic dimension, apart from the need to improve the efficiency of budget expenditures. These funds would help prevent fiscal consolidation from becoming pro-cyclical, especially during a deep recession. They could raise economic growth potential, which has arguably been lowered by the current financial crisis.

Hidden Budget Imbalances

Europe's sovereign debt crisis has heightened policy concerns over *fiscal sustainability*. Governments' responses during this crisis illustrate, once again, that trying to avoid a systemic collapse burdens the public debt. Consequently, stronger fiscal discipline should be seen in conjunction with policies addressing macroeconomic imbalances. The criterion of public debt should be reflected in the budgetary surveillance mechanism with a focus on "fiscal sustainability" and with more attention given to the interplay between debt and deficit. Quite likely, the Council Task Force and the EU Commission experts had in mind Ireland and Spain, when thinking of this aspect. Both of these countries, as members of the EMU, did not show budget profligacy prior to the crisis.

Except for Hungary, NMSs do not have large public debts. However, budget deficits have gone up dramatically in the wake of the financial crisis (Figure 1). In several NMSs pains in the private sector were transmitted to the public sector through a considerable reduction in the level of budget revenues and of increased deficits as a result of the deleveraging process. Therefore, fiscal consolidation has to consider the risk of adding public deleveraging to the ongoing private deleveraging, for it could damage the economic recovery[2]. In addition, there is also a risk of implementing budget strategies based on overly optimistic assumptions and of endangering the sustainability of public finances.

A sharp rise in budget deficits, in the wake of the current crisis, may not be a temporary affair, particularly when there were years of resource misallocation, structural budget deficits hidden by bubbles and non-sustainable economic growth. This is exemplified in the Baltic states, Bulgaria and Romania. In these countries economic growth was fuelled by a very rapid expansion of credit, driven by massive capital inflows, and increased following the opening of the capital account. Therefore, fiscal consolidation programs are necessary where arguably, a permanent loss of output and economic growth prospects are impaired. With the threat of a spreading sovereign crisis, markets would not tolerate

[1] Outside Europe and learning from previous crises, emerging economies tried to forestall shocks by the accumulation of foreign exchange reserves as a buffer (a high premium was attached to them); uphill financial flows were seen as a cost for the buildup of a wherewithal capacity in the advent of unanticipated shocks.

[2] Becker Torbjorn and Daniel Daianu, Zsolt Darvas, Vladimir Gligorov, Michael Landesmann, Pavle Petrovic, Jean Pisani-Ferry, Dariusz Rosati, Andre Sapir, Beatrice Weder Di Mauro, (2010), "Whither Growth in Central and Eastern Europe? Policy Lessons for an Integrated World", Bruegel Blueprint Series, p.131.

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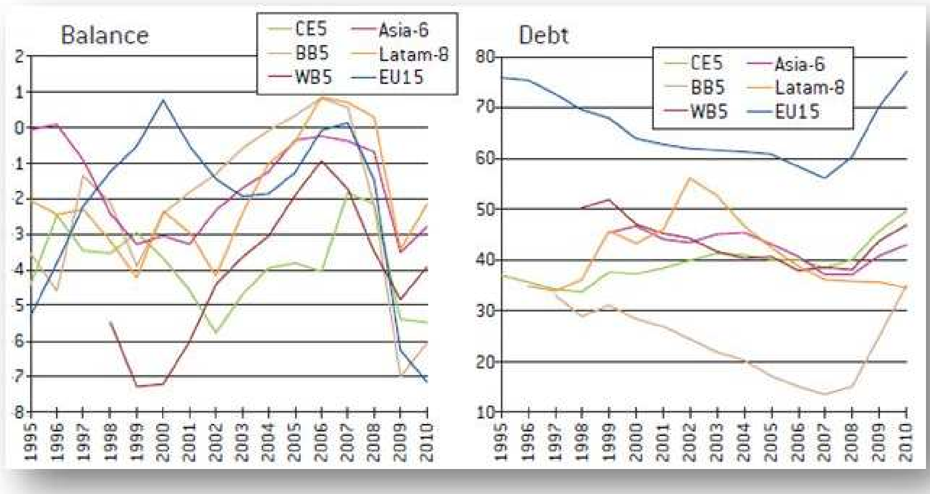
persistently high structural deficits. Moreover, rising interest rates (not least owing to worsened international credit markets and crowding out effects exerted by big economies' borrowing needs) bring the specter of a debt service snowball effect to the fore[3]. A positive differential between the GDP growth rate and the interest rate should be a sufficient condition for stabilizing the size of public debt provided this differential is superior to the budget primary deficit as a share of GDP. But, if there is a jump in the interest rate this differential can become inferior to the primary deficit, or even turn negative. Moreover, if this reversal lasts the debt service turns into a destabilizing element in public debt dynamics. The fundamental question becomes how to undertake fiscal consolidation without becoming mired into vicious circles, especially when the external environment is pretty hostile.

FIGURE 1: GENERAL GOVERNMENT BALANCE AND GROSS DEBT (% OF GDP) 1995-2010



- CES5: Czech Republic, Hungary, Poland, Slovakia and Slovenia
- BB5: Bulgaria, Estonia, Latvia, Lithuania and Romania
- WB (western Balkans EU candidate countries): Albania, Bosnia and Herzegovina, Croatia, Former Yugoslav Republic of Macedonia, Montenegro and Serbia
- EU15: the 15 members of the EU before 2004
- Asia6: Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand
- Latin America8 (Latam-8): Argentina, Brazzil, Chile, Columbia, Ecuador, Mexico, Peru and Uruguay

Source: Bruegel Blueprint Series, "Whither Growth in Central and Eastern Europe? Policy Lessons for an Integrated World"

The Threat of Pro-Cyclical Fiscal Consolidation

During the crisis Central and Eastern Europe was one of the worst hit regions in the world. Except for Poland, its economies tumbled at a rapid rate while budget deficits soared. Trade, and more importantly, financial shocks have compounded internal difficulties and made budget revenues collapse throughout NMSs. This environment has brought back the International Monetary Fund (IMF) and other International Financial Institutions (IFIs) into the picture, in full force. Stabilization programs, which are based on their financial support, have become a necessity in several NMSs for the sake of averting sovereign defaults. However, it should be noted that there are significant differences among NMSs. Some of these differences are rooted in varying exchange rate and monetary policy arrangements. For instance, some countries (Latvia, Lithuania, Estonia and Bulgaria) peg their currencies (via currency boards), while others have floating exchange rate regimes. Likewise, different economic and budget policy histories also matter in the architecture of stabilization programs as well as the room for policy maneuver. Even though pain is unevenly distributed among NMSs, all of them suffer considerably.

Currency boards raise a major challenge when it comes to the capacity for absorbing shocks and undertaking adjustments. Unless markets (labor market included) are flexible enough, shocks can hardly be absorbed and the exchange rate and monetary policy arrangements become untenable. The policy dilemma in the Baltic states (and not least Bulgaria) depends on their capacity to improve competitiveness quickly and adjust to the new international context. This highlights the arguments among those who believe that exchange rate devaluation is preferable to internal devaluation, while others point at the ubiquitous wealth effect of such a move (because of heavy Euroization) and the further erosion of banks' balance-sheets.

For instance, due to high Euroization and the high sensitivity of domestic prices to exchange rate depreciation, the Romanian government relies on drastic cuts in public sector expenditures (instead of revenues) in its adjustment programs. Latvia's experience with internal devaluation has defied dire predictions, but it may still be too early for a final verdict. Floaters, too, are facing major challenges since their budget revenues have also decreased sharply. For instance, due to high Euroization and the high sensitivity of domestic prices to exchange rate depreciation, the Romanian government relies on drastic cuts in public sector revenues in its adjustment programs. Consequently, some argue that such an approach does

[3] Countries can default in spite of not having excessively large public debts. Sturzenegger, Federrico and Jeromin Zettelmeyer (2006), „Debt Defaults and Lessons from a Decade of Crises", Cambridge (MA), MIT Press.

not capitalize on exchange rate flexibility as a means to mitigate the pro-cyclicality of fiscal consolidation. It may be the case that stunningly high increases in public sector wages in the Baltic states and Romania, during the years preceding the current crisis, gave governments the audacity to resort to their sharp cuts as fiscal consolidation measures.

For many NMSs high hopes and expectations are pinned down on economic recovery in Germany and other EU member countries. However, unless the recovery gets solid traction economic gains will be insufficient. In addition, the economic downturn adds new pressure on banks. They are in a process of deleveraging (driven by parent banks from outside the region), which limits their propensity to lend. At the same time, abandoning their clients would make matters worse. The "Vienna Initiative" (which brought together banks, several NMS governments, the EU and IFIs) has tried to induce banks to roll over their clients' debts so that a breakdown of financial intermediation can be averted. Yet problems remain, for credit markets are functioning quite precariously, which suffocates many local companies.

Improving the efficiency of budget expenditures would bring about major economic benefits. Waste and fund embezzlement is pretty high in most NMSs, diminishing the capacity of national budgets to supply essential public goods. Higher efficiency would increase this supply and significantly improve fiscal consolidation.

At the start of 2009 the European Commission simplified procedures for the absorption of EU funds, but this is not enough in light of the severity of the economic crisis in most NMSs. Moreover, the IFIs and EU funded stabilization programs have not avoided pro-cyclicality albeit the IMF has shown a substantial amount of flexibility in their design.

EU Funds: An Additional Mission is Badly Needed

EU structural and cohesion funds can make a significant impact, increasing GDP by 4-5% in most NMSs. EU funds can be the equivalent of budget policy activism which is practiced in the U.S. and some major EU economies. Without entailing higher deficits, they could offset the pro-cyclical features of IFIs supported fiscal consolidation programs. Here, it pays to consider that this economic crisis can have highly deleterious social effects, which have to be accounted for by current adjustment programs. Just think about the nominal cuts of revenues of average citizens in Latvia, Hungary, Romania and other economies in the region.

Budget deficits are a critical issue for NMSs. Even Poland, which has avoided a major recession, is estimated to have incurred a budget deficit of over 6.5% in 2010. Economic growth in Central and Eastern Europe will be sharply reduced in the years to come, though substantial differences will exist among various countries. As already stated, a permanent loss of output has, quite likely, occurred in those NMSs where there were years of resource misallocation. There is also the reality of EU budget rules against the backdrop of unstable financial flows. This combination of premises makes it plausible that budget revenues will not enlarge as needed. All this makes it more urgent to find ways to increase the use of EU funds in the NMSs and even give them a new mission.

The Commission also has to be more imaginative and take the lead in enhancing EU funds absorption as a means to combat the economic crisis –apart from the traditional objectives of fostering convergence and implementing the CAP. Speeding up disbursements, increasing pre-financing and dropping the requirement of co-funding in the case of unquestionably useful projects have to be a major focus of the Commission. Likewise, EU funds can be used to buttress the capital of local banks or to set up financial institutions dedicated to enhancing rural modernization and development. The EC should use EU funds to support projects of regional importance. In this regard, the Danube Strategy offers an excellent venue.

After World War II institutions were devised, primarily in Western Europe, to tackle reconstruction and revive key economic sectors. This crisis demands a corresponding vision and creative policy response. Corruption is rife and institutions are weak in most NMSs. But this is not an argument for inaction and procrastination. This crisis has triggered exceptional responses in the Euro zone and the U.S. A similar policy thrust should apply to the use of EU funds in NMSs. The stakes are too high for vacillating. The bottom line is this: more capital has to flow into NMSs in order to fund the production of capital goods during a time when national budgets are extremely strained. This period may last for years, but inaction may lead to future political and economic instability in the region. EU funds can help avoid the emergence of a new divide inside the EU and across the whole of Europe.

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