Box 9

THE IMPACT OF THE GLOBAL FINANCIAL AND ECONOMIC CRISIS ON PUBLIC FINANCES IN CENTRAL AND EASTERN EUROPE

When the global financial and economic crisis took hold, fiscal positions in most of the EU countries in central and eastern Europe outside the euro area (CEE) deteriorated markedly.[1] This box analyses the factors that rendered these countries' public finances vulnerable to the economic downturn and outlines major challenges for their fiscal policies in the aftermath of the crisis.

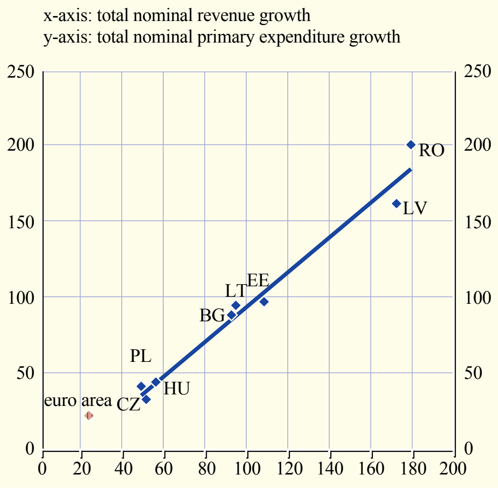
Fiscal policies prior to the crisis

The economic boom in most CEE countries in the years prior to the crisis generated buoyant general government revenue growth. However, this boost to revenues was mostly used not to build up fiscal buffers but instead to significantly increase primary public expenditure, to a sizeable extent on less productive items such as public pension increases and rapidly rising public wages. As Chart A indicates, the positive relationship between revenue and primary expenditure growth in the years prior to the crisis was most pronounced in Romania and Latvia, followed by Estonia, Lithuania and Bulgaria. Overall, this public spending behaviour can be taken as an indication that the budgetary frameworks in these countries did not provide the necessary expenditure constraints when revenue growth accelerated with temporarily rapid economic growth. As a consequence, almost all CEE countries entered the crisis with weak structural budgetary positions, which made public finances vulnerable to the sharp economic downturn. As Chart B shows, on the basis of ex-post data, all CEE countries except Bulgaria recorded structural deficits prior to the crisis despite a still very favourable macroeconomic

1 This box covers the eight central and eastern European EU countries that had not adopted the euro in 2010.

Chart A Nominal revenue and primary expenditure growth in the period 2003-07

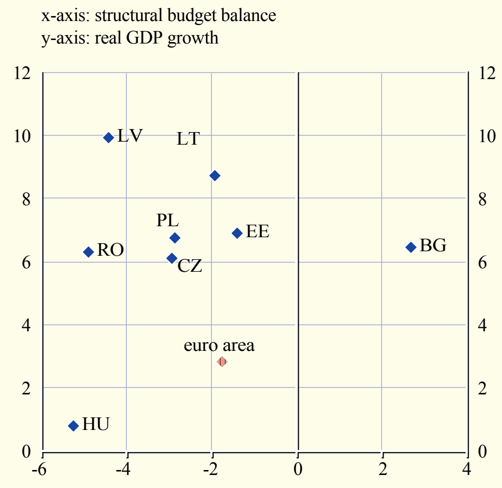
(percentage changes)



Sources: Eurostat, European Commission and ECB calculations.

Chart B Structural budget balances and real GDP growth in 2007

(percentages of GDP; annual percentage changes)



Sources: Eurostat, European Commission and ECB calculations.

Fiscal positions in the period 2007-12

	Budget balance						General government gross debt				
	level (percentages of GDP)				change (percentage points)		level (percentages of GDP)				change (percentage points)
	2009	2010	2011	2012	2007-09	2009-12	2009	2010	2011	2012	2007-12
Bulgaria	-4.7	-3.2	-2.7	-1.6	-5.8	3.0	14.6	16.2	18.0	18.6	1.4
Czech Republic	-5.9	-4.7	-4.4	-4.1	-5.2	1.8	35.3	38.5	41.3	42.9	14.0
Estonia	-1.7	0.1	-0.6	-2.4	-4.3	-0.6	7.2	6.6	6.1	6.9	3.2
Latvia	-9.7	-7.7	-4.5	-3.8	-9.3	5.8	36.7	44.7	48.2	49.4	40.4
Lithuania	-9.5	-7.1	-5.5	-4.8	-8.5	4.7	29.5	38.2	40.7	43.6	26.6
Hungary	-4.5	-4.2	1.6	-3.3	0.5	1.2	78.4	80.2	75.2	72.7	6.6
Poland	-7.3	-7.9	-5.8	-3.6	-5.5	3.7	50.9	55.0	55.4	55.1	10.1
Romania	-8.5	-6.4	-4.7	-3.6	-5.9	4.9	23.6	30.8	33.7	34.8	22.2
Euro area	-6.3	-6.0	-4.3	-3.5	-5.7	2.8	79.3	85.4	87.7	88.5	22.3

Sources: Eurostat and European Commission's spring 2011 economic forecast.

environment. The three CEE countries that had to call on the IMF and the EU for financial support entered the crisis with the largest structural deficits: in 2007 Hungary recorded a structural deficit of 5.2% of GDP, followed by Romania with 4.9% and Latvia with 4.4%.

The response of fiscal policies to the crisis

All CEE countries except Hungary experienced soaring budget deficits over the period from 2007 to 2009 (see table). This deterioration reflected the sharp fall in GDP growth, a move from revenue windfalls to revenue shortfalls and a delayed adjustment in expenditure over the period. The latter related in particular to rises in pension benefits and public wages agreed ahead of the crisis. All countries responded to the crisis by consolidating their public finances.[2] In 2010, budget balances improved in all countries except Poland. For 2011, all countries except Estonia (where a slight surplus was recorded for 2010) are projected to reduce their budget deficits further or move into surplus. According to these projections, Poland will, as in 2010, record the highest budget deficit (5.8% of GDP). In Hungary, which is expected to improve its budget balance by 5.8 percentage points to achieve a surplus of 1.6% of GDP, and in Poland, fiscal consolidation relates to a considerable extent to the revenue-raising impact of recent pension system adjustments.[3]

Fiscal policy challenges in the aftermath of the crisis

In most CEE countries a greater structural fiscal effort in line with commitments under countries' excessive deficit procedures is required to limit the rise in debt-to-GDP ratios and to further rebuild confidence in fiscal sustainability.[4] To contain the pressures on fiscal sustainability arising

2 For an overview of the CEE countries' fiscal responses to the crisis, see the article entitled "The impact of the financial crisis on the central and eastern European countries", *Monthly Bulletin*, ECB, July 2010. See also Box 2, entitled "The experience of macroeconomic adjustment in the Baltic States", in this issue of the Monthly Bulletin for more details on the key elements of the adjustment strategies in Estonia, Latvia and Lithuania in response to the crisis.

3 In Hungary, the mandatory private pension scheme was effectively abolished earlier this year. The related transfer of pension assets implies a substantial one-off increase in revenues and thus has a deficit-reducing impact. In both countries the adjustments involve lower contributions under the mandatory private pension pillar in exchange for the revenue-raising impact of higher contributions under the public pension scheme.

4 Apart from Estonia, all CEE countries are subject to an EU Council decision on the existence of an excessive deficit. The Council recommendations provide guidance on average annual structural fiscal consolidation requirements. The deadlines to correct the excessive deficits are 2011 for Bulgaria and Hungary, 2012 for Latvia, Lithuania, Poland and Romania, and 2013 for the Czech Republic.

from demographic changes, further reforms are needed to increase the long-term sustainability of pension schemes. Fiscal measures entailing higher contributions to public pay-as-you-go pension schemes at the expense of lower contributions to a funded pension pillar must be closely monitored for their potentially detrimental impact on long-term fiscal sustainability. To maximise the beneficial impact of fiscal consolidation, governments should aim to improve the growth-friendliness of public expenditure. Stringent fiscal frameworks with strict public expenditure rules are needed to improve budgetary discipline and avoid pro-cyclical fiscal slippages in the future. Bold steps in this direction would enhance financial market confidence in the prudence of the CEE countries' fiscal policies.