The Boom-Bust in the EU New Member States: The Role of Fiscal Policy

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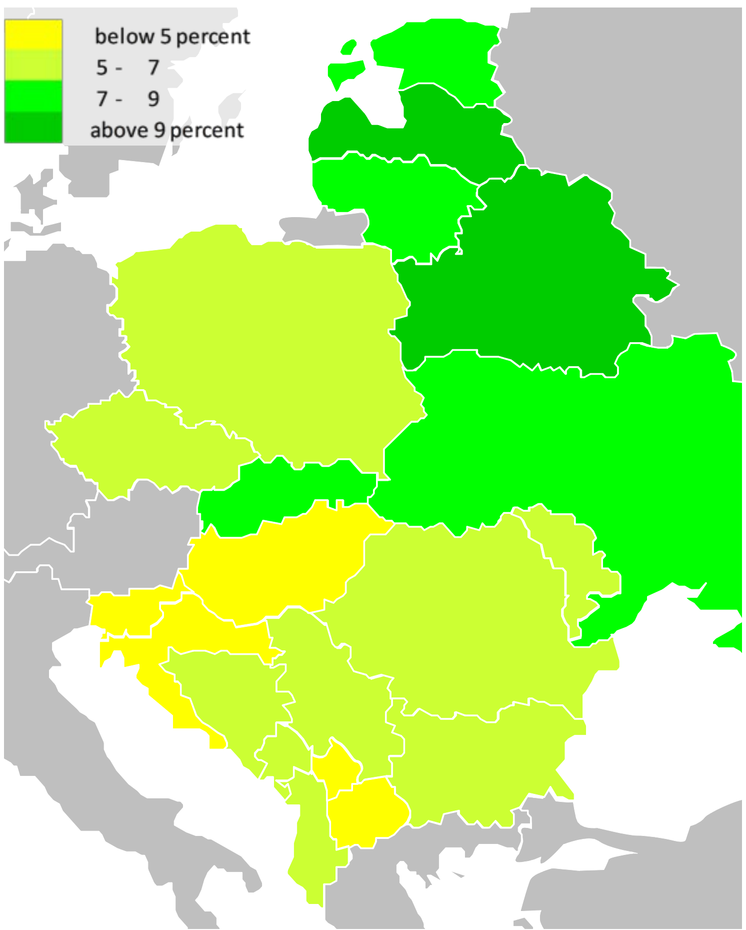
Outline

- The boom-bust in CESEE
- Fiscal policy and the boom-bust
- Concluding thoughts

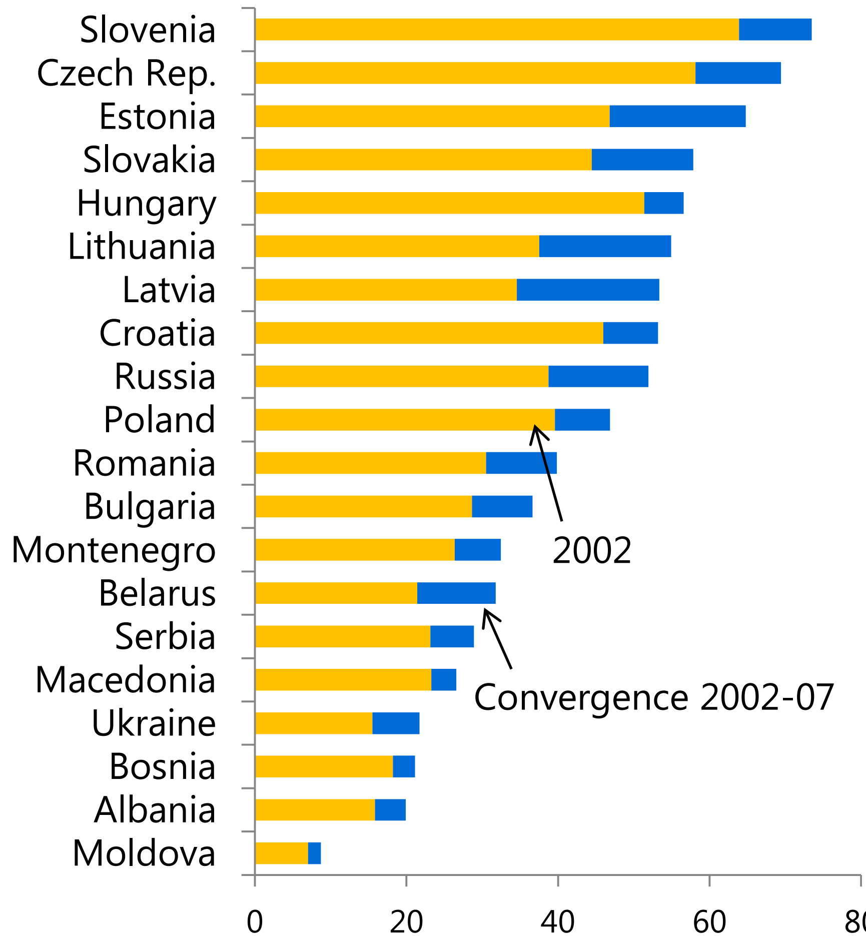
The Boom-Bust in CESEE

Pre-crisis, income levels in CESEE converged rapidly with Western Europe…

Average annual GDP growth (percent)

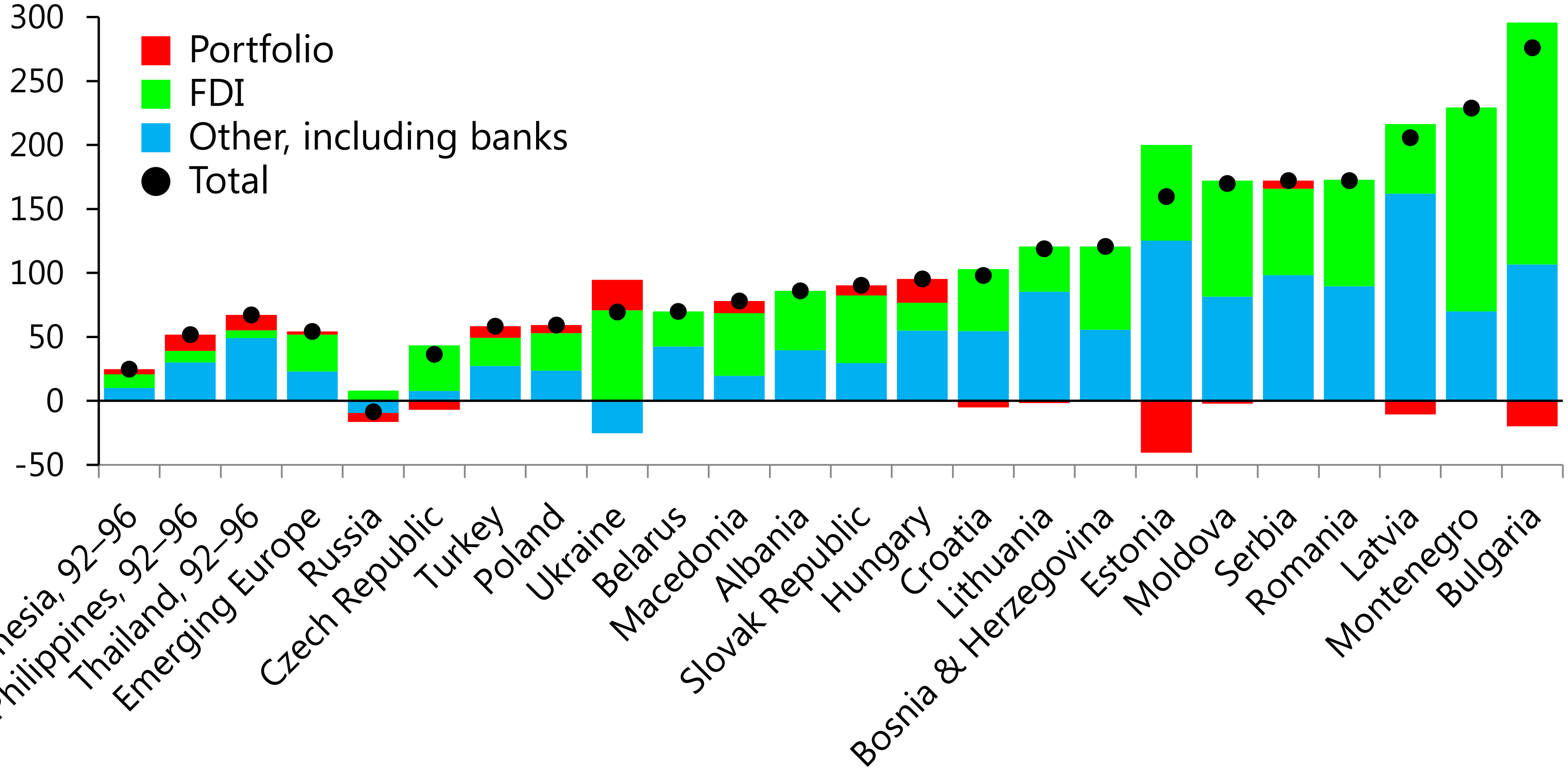


GDP per capita level relative to Germany (percent)



…fueled by strong capital inflows.

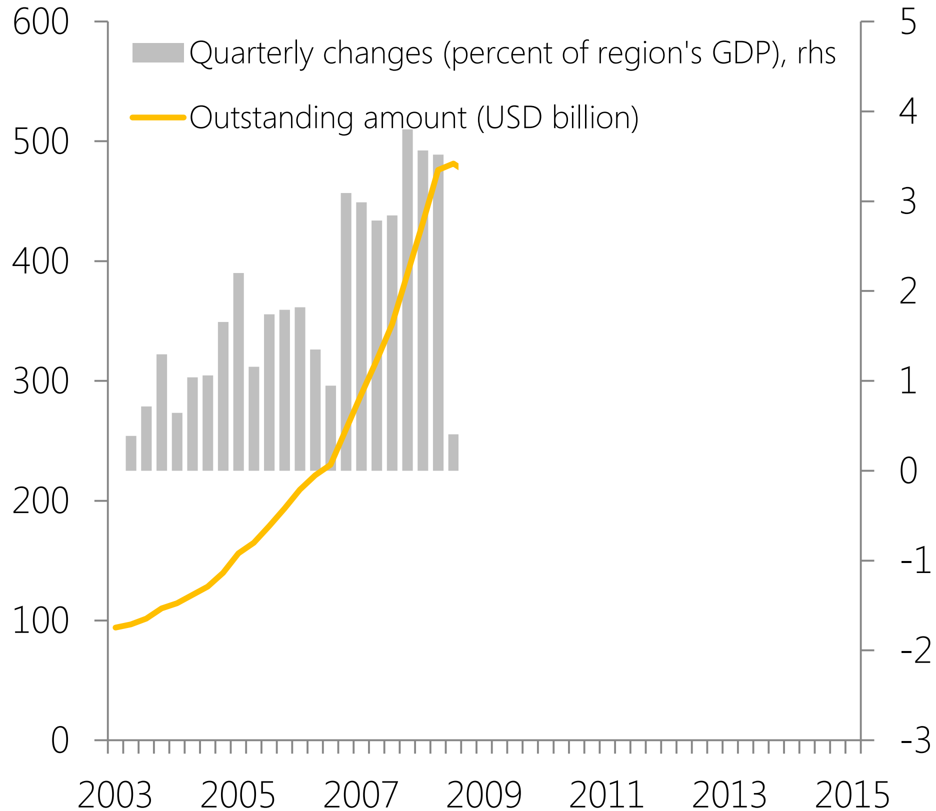
Cumulative Net Capital Inflows, 2003–08*
(Percent of 2003 GDP)



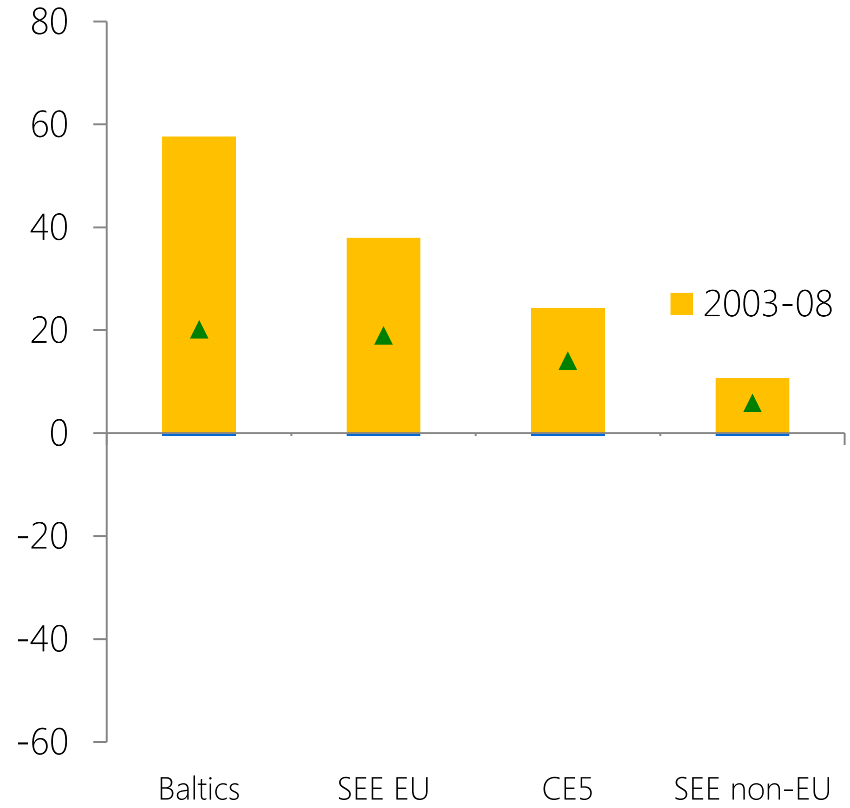
*As the boom in the Baltic states ended in 2007, data for the Baltic states refer to 2002–07 in percent of 2002 GDP.

Western European banks were an important source of capital flows

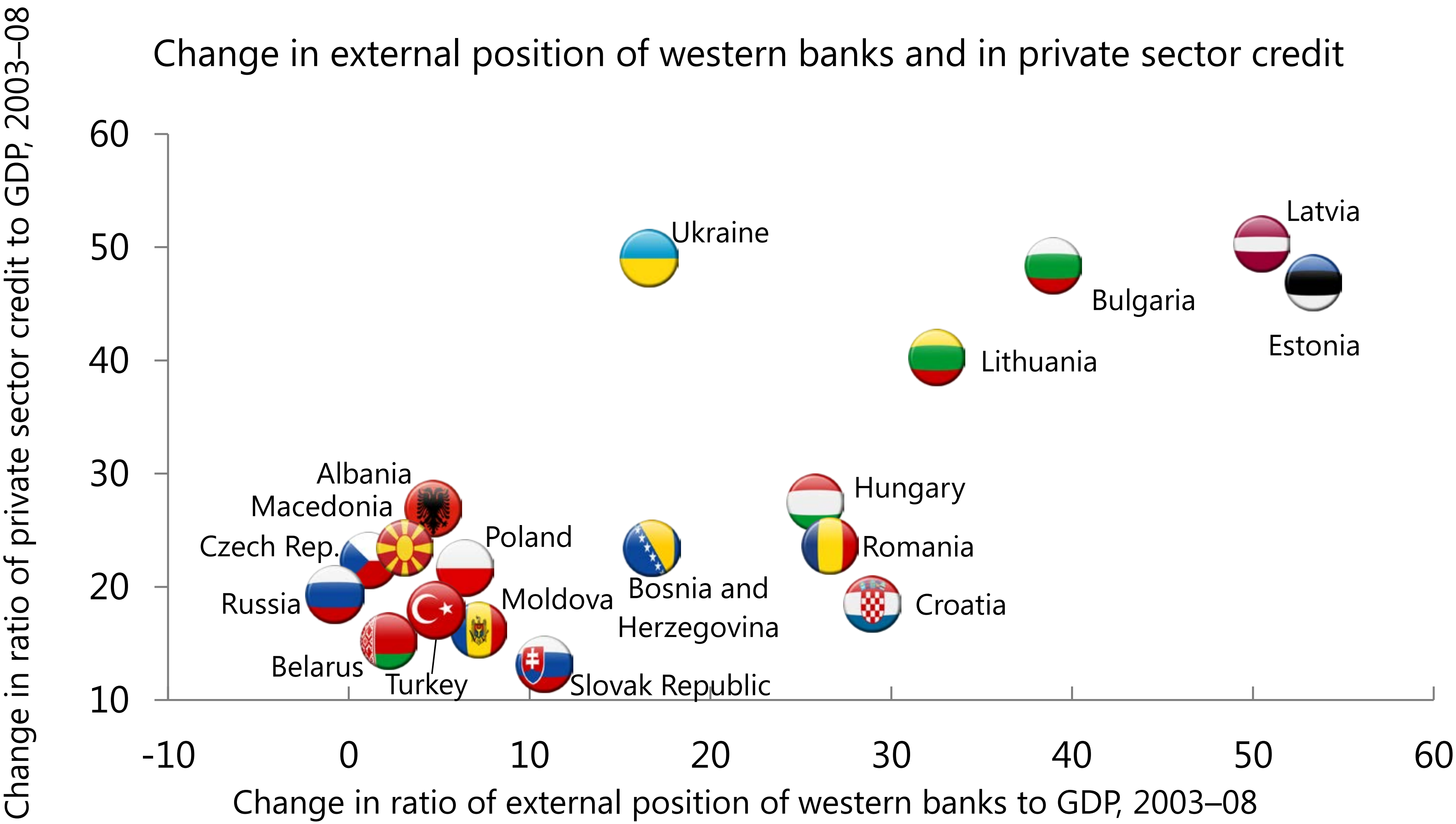
Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)



Changes in exposure of BIS-reporting banks (percent of 2015 GDP)

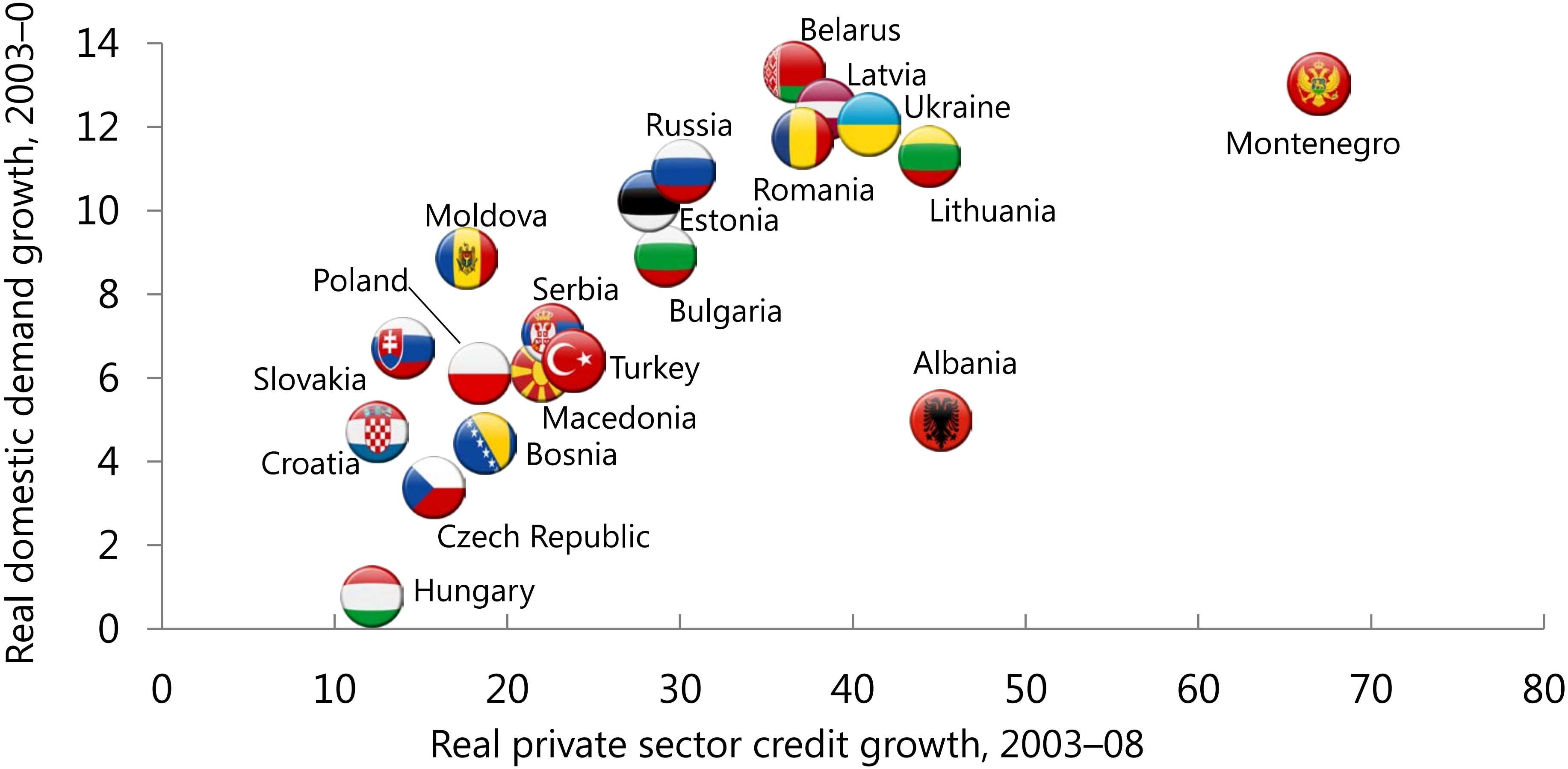


Bank flows fueled a credit boom…

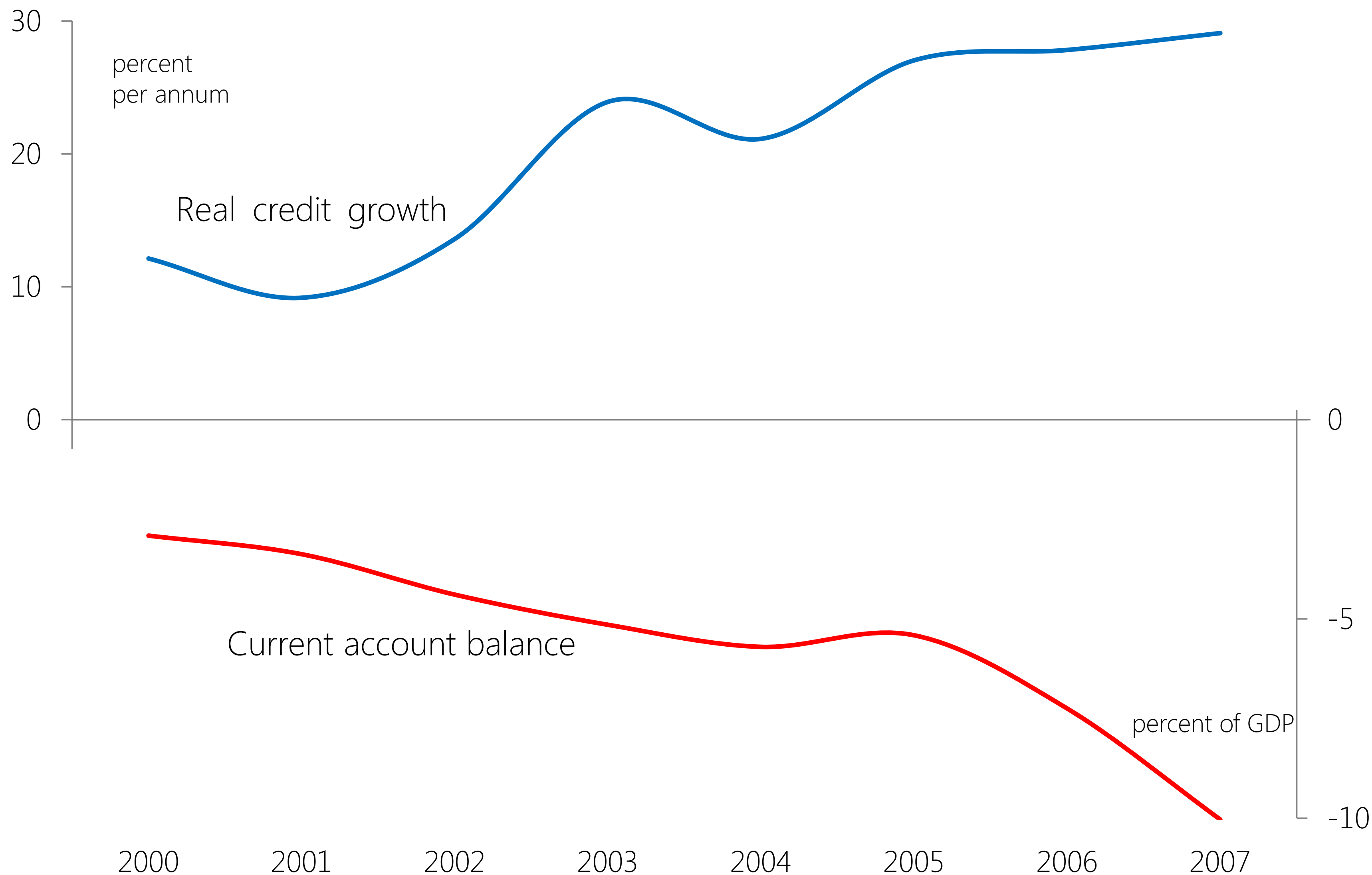


… which boosted domestic demand.

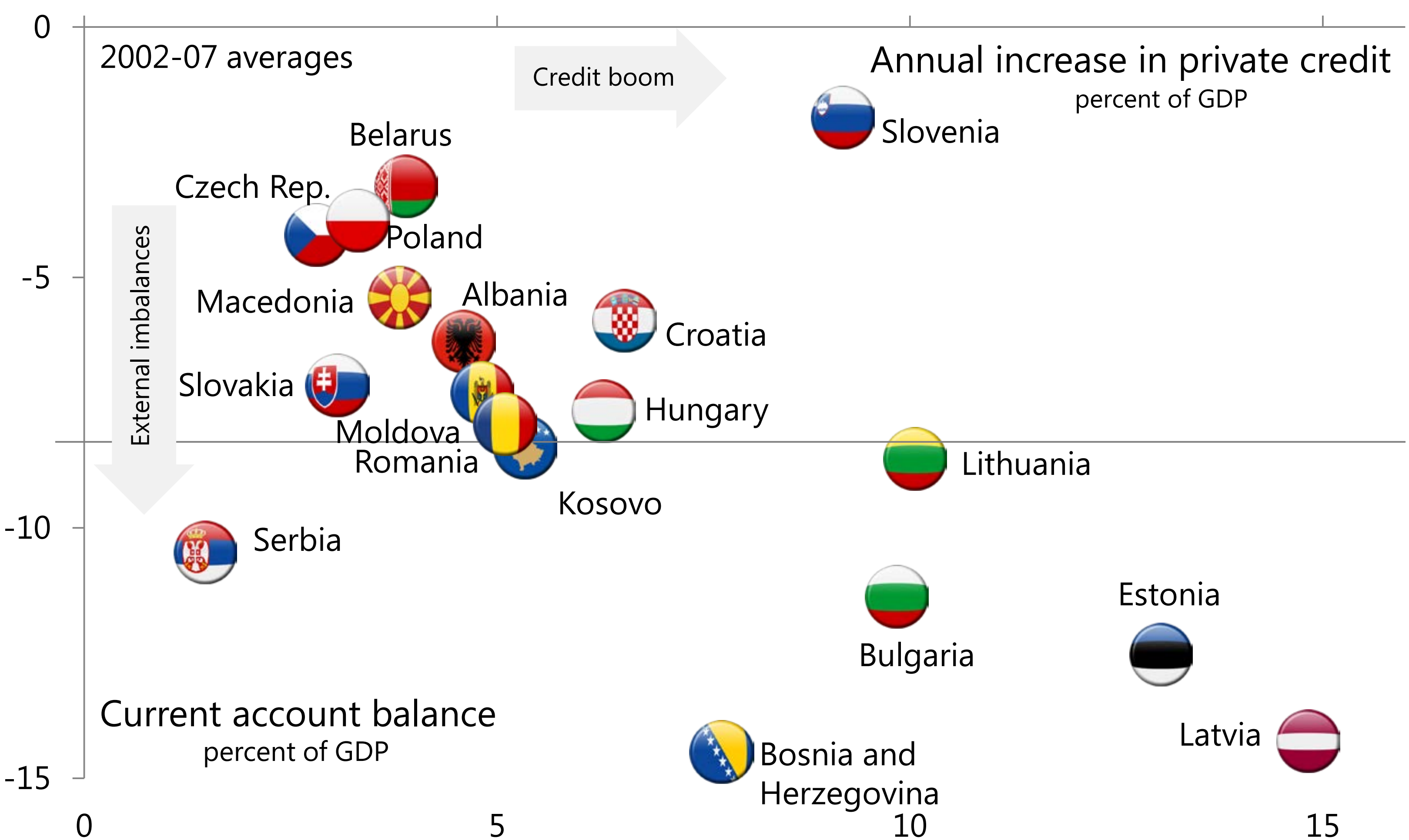
Domestic Demand and Private Sector Credit Growth, 2003–08[1]
(Annual percentage change)



Rapid credit growth was associated with rapidly rising current account deficits



Current account deficits in some countries reached very high levels

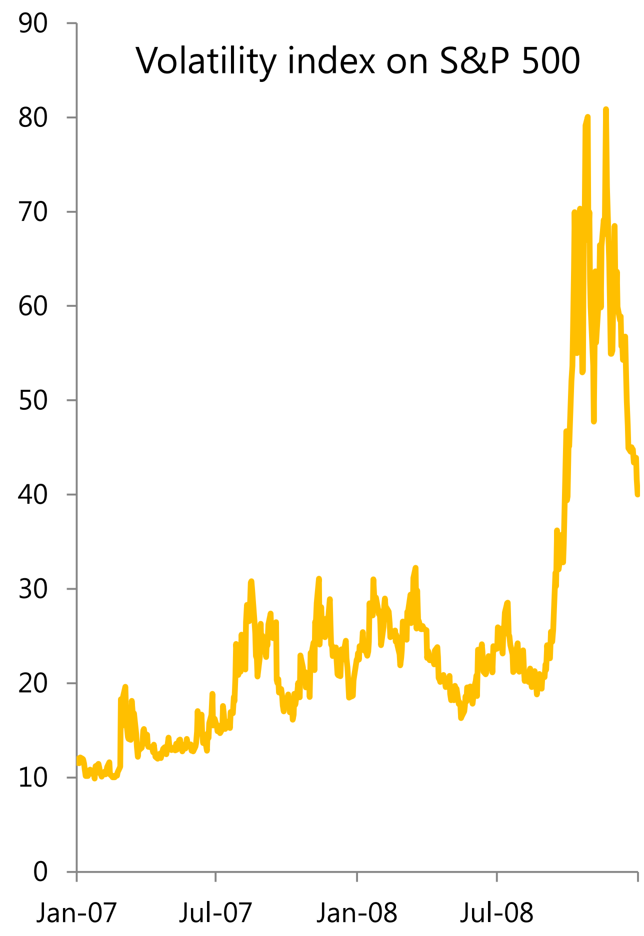


But views differed on how to interpret these imbalances

- Abiad, Leigh, and Mody (2007): "International Finance and Income Convergence: Europe is Different"➔
  - Current account deficits are benign.
  - Capital flowing from rich to poor countries
- Bakker and Vladkova-Hollar (2006): "Asia 1996 and Eastern Europe 2006: Deja-vue all over again"?

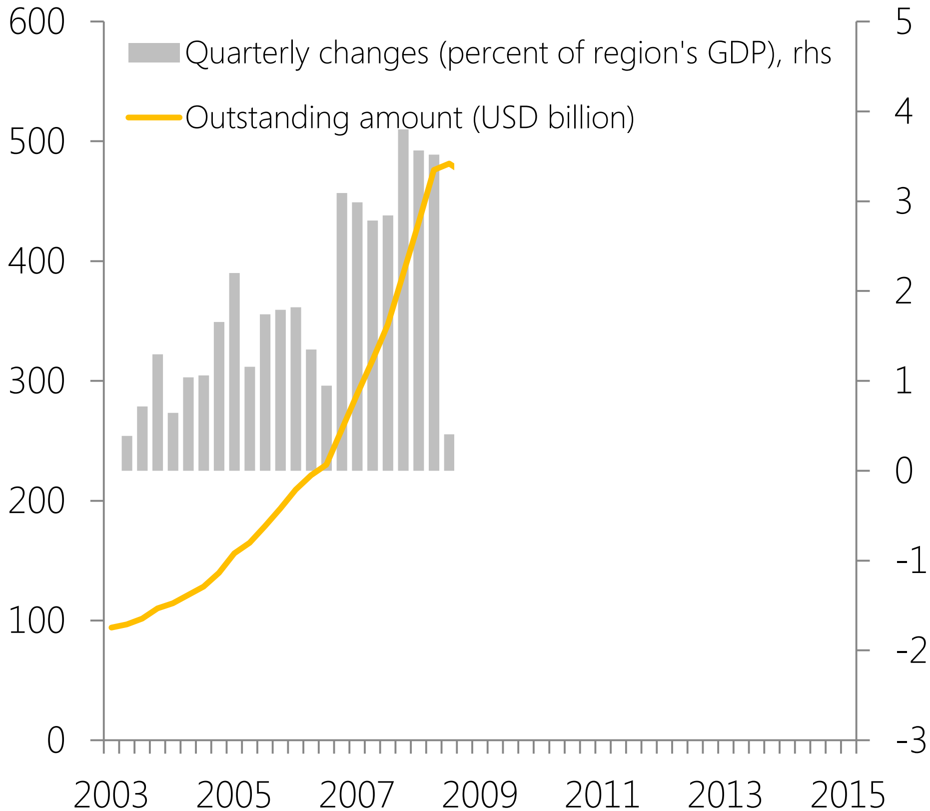
In September 2008, Lehman Brothers defaulted

- Global risk aversion spiked
- Western European banks came under financing pressure
- As a result they suddenly stopped sending large amounts of capital to CESEE
- Domestic demand collapsed just when exports dropped because of global recession

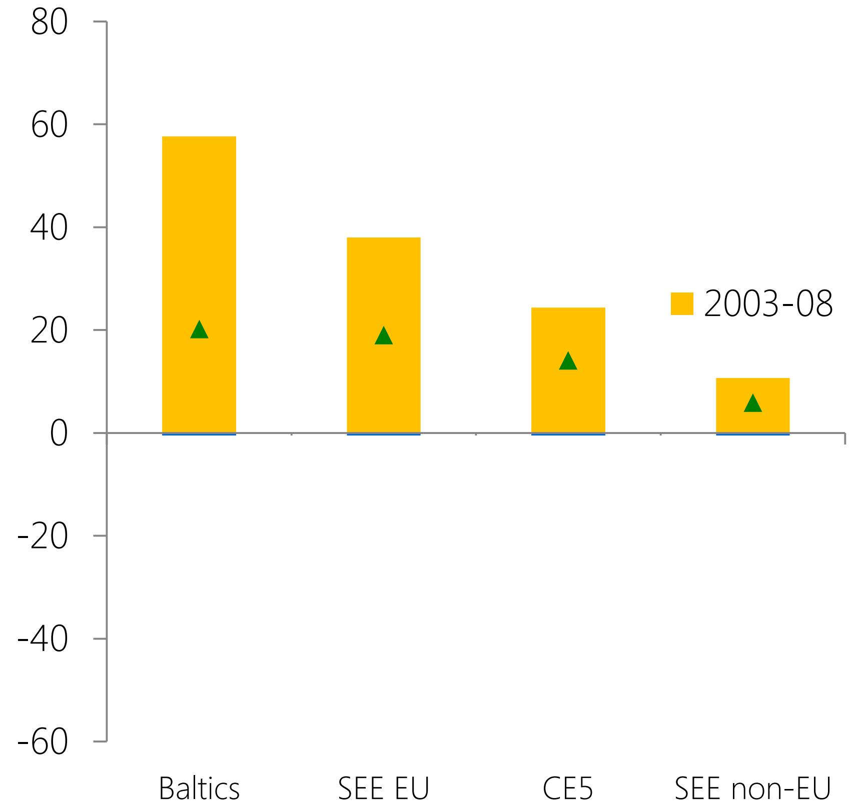


The result was a sudden stop—and then reversal—of bank flows

Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)

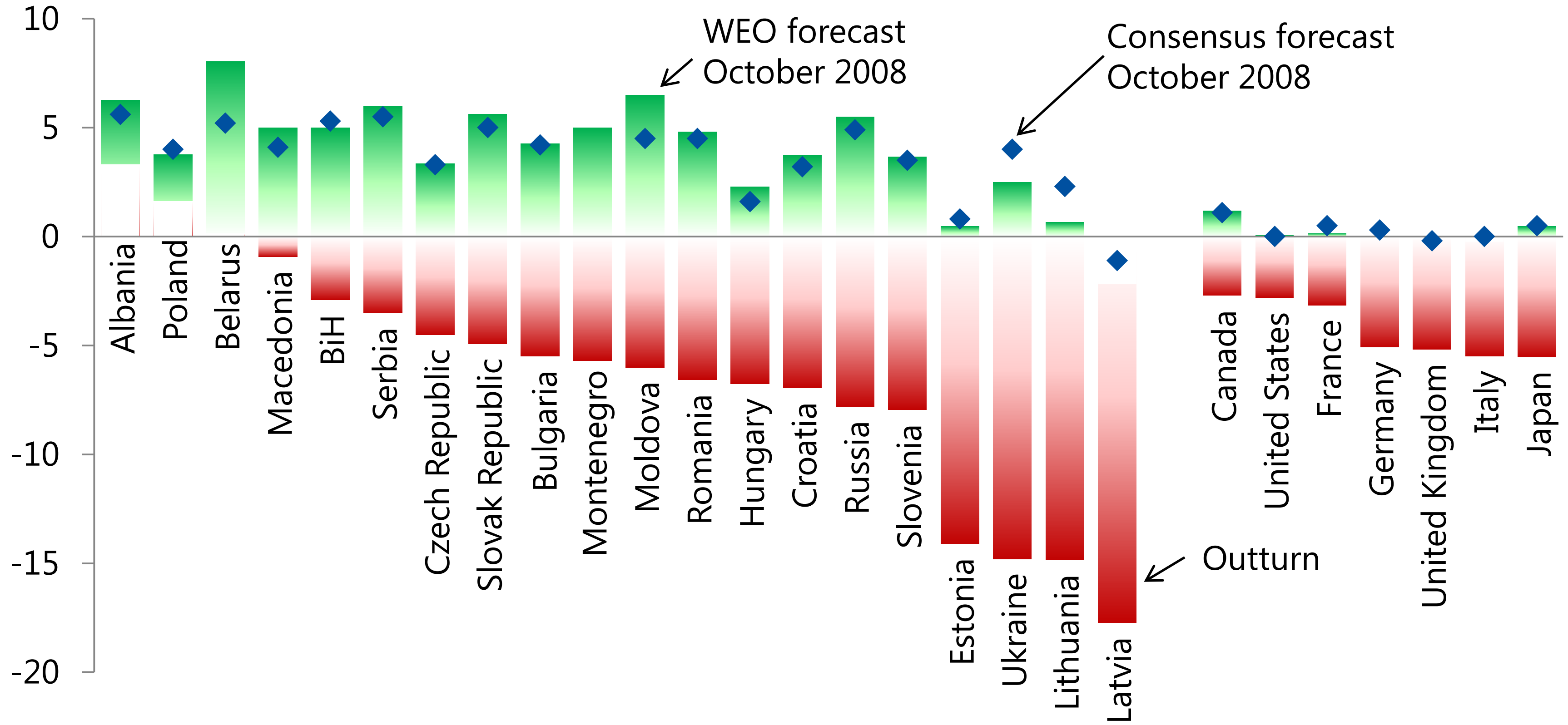


Changes in exposure of BIS-reporting banks (percent of 2015 GDP)

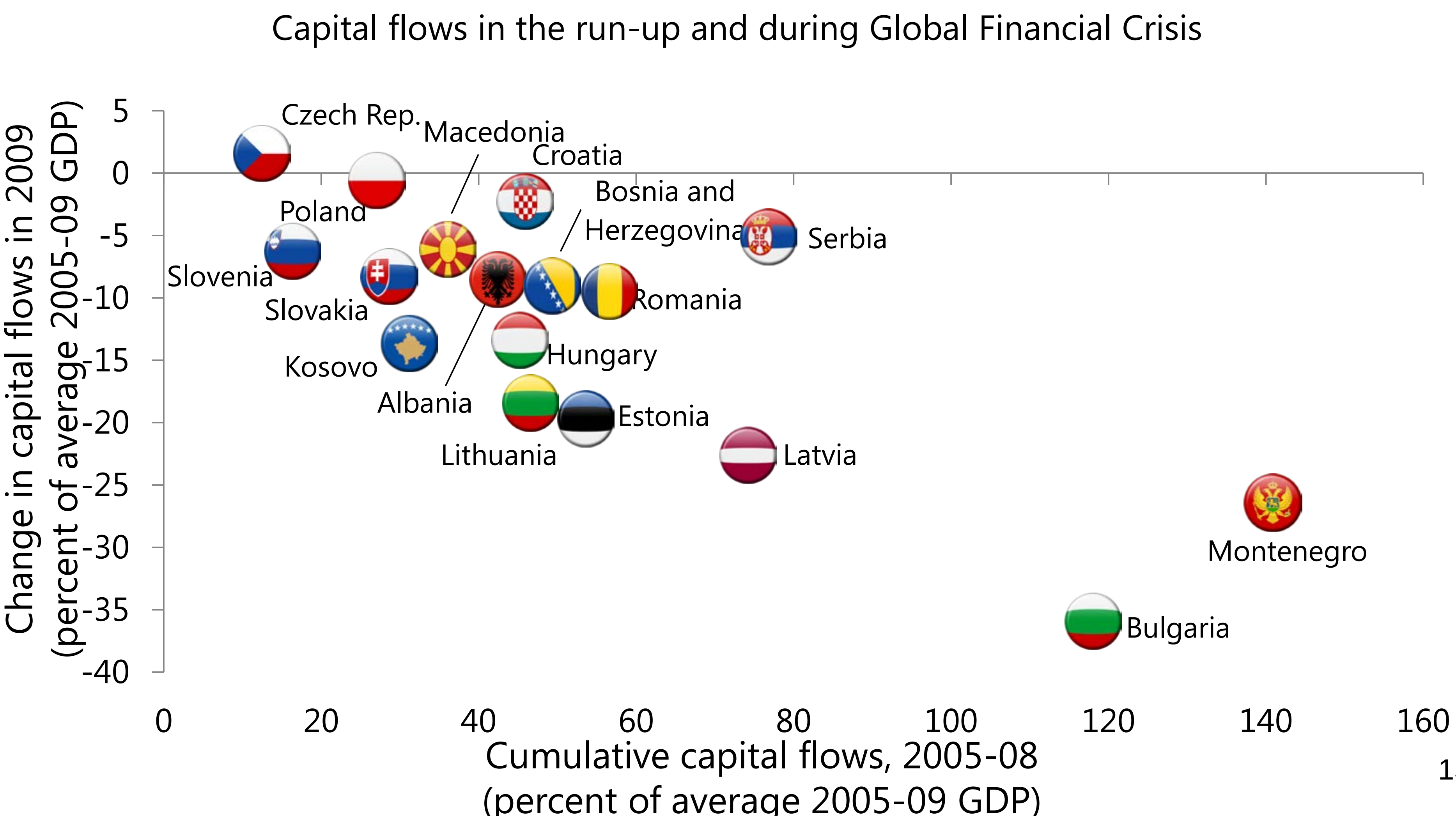


The result was a deep recession—which was not projected by most observers

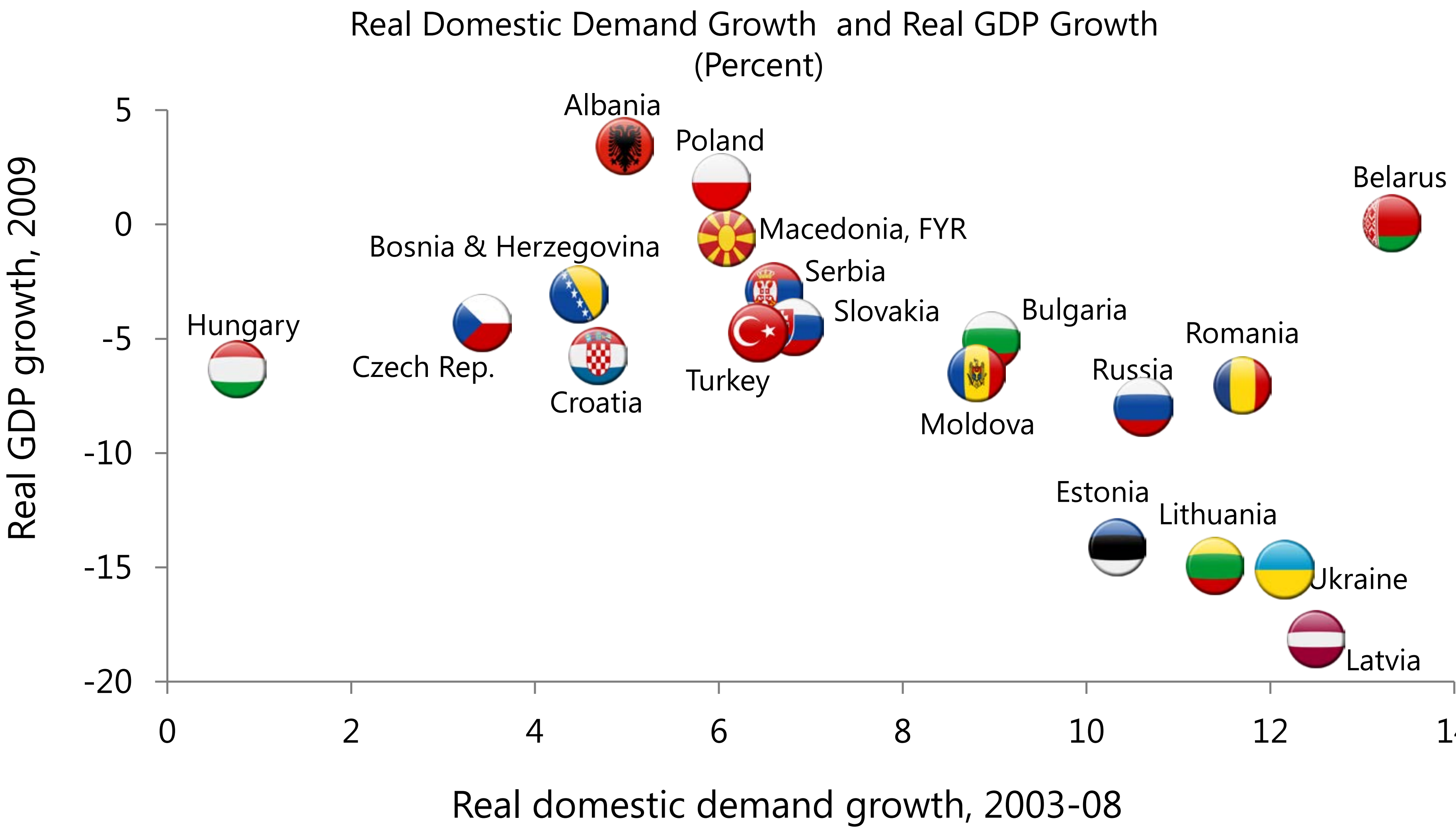
Real GDP growth in 2009 (percent)



The larger previous capital inflows, the sharper the reversal



Countries which had large domestic demand booms, now saw deep recessions



The IMF was quick to provide assistance

EU countries:

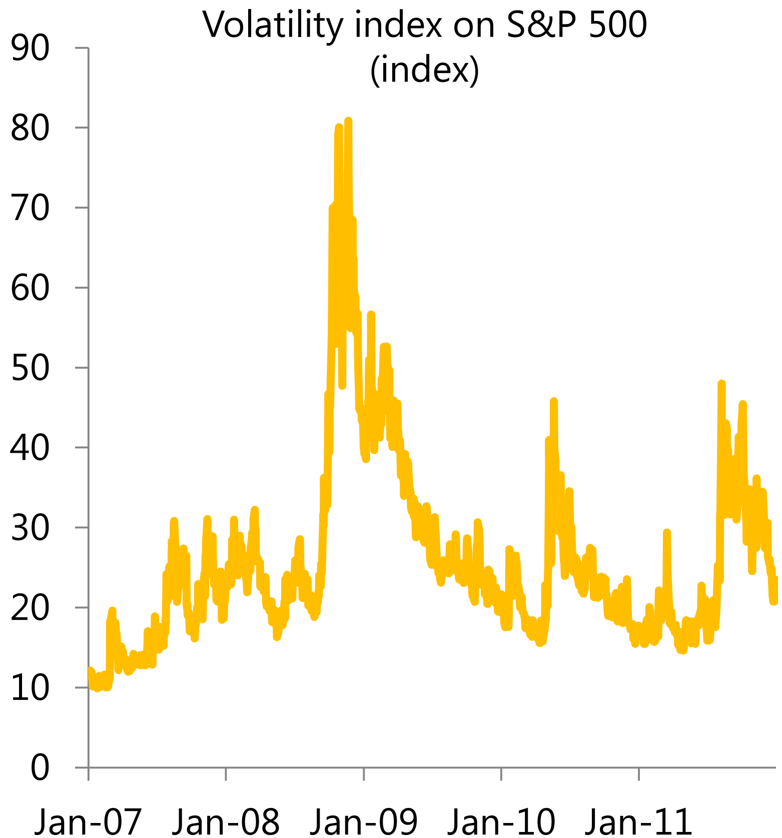
- EU member countries
- SBA program
- FCL program

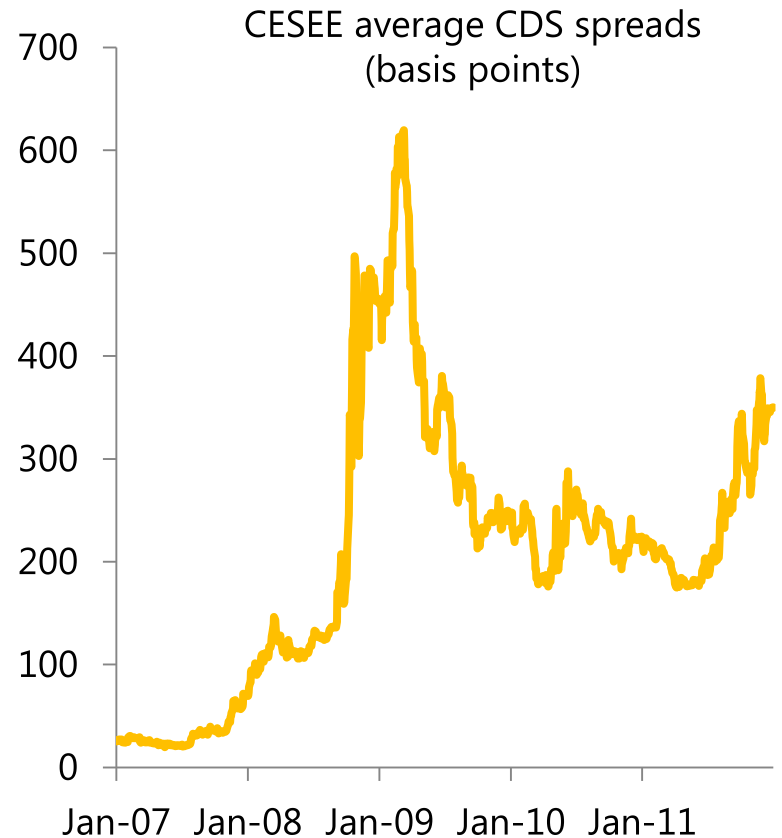
Non-EU countries:

- SBA program
- EFF program
- PCL program

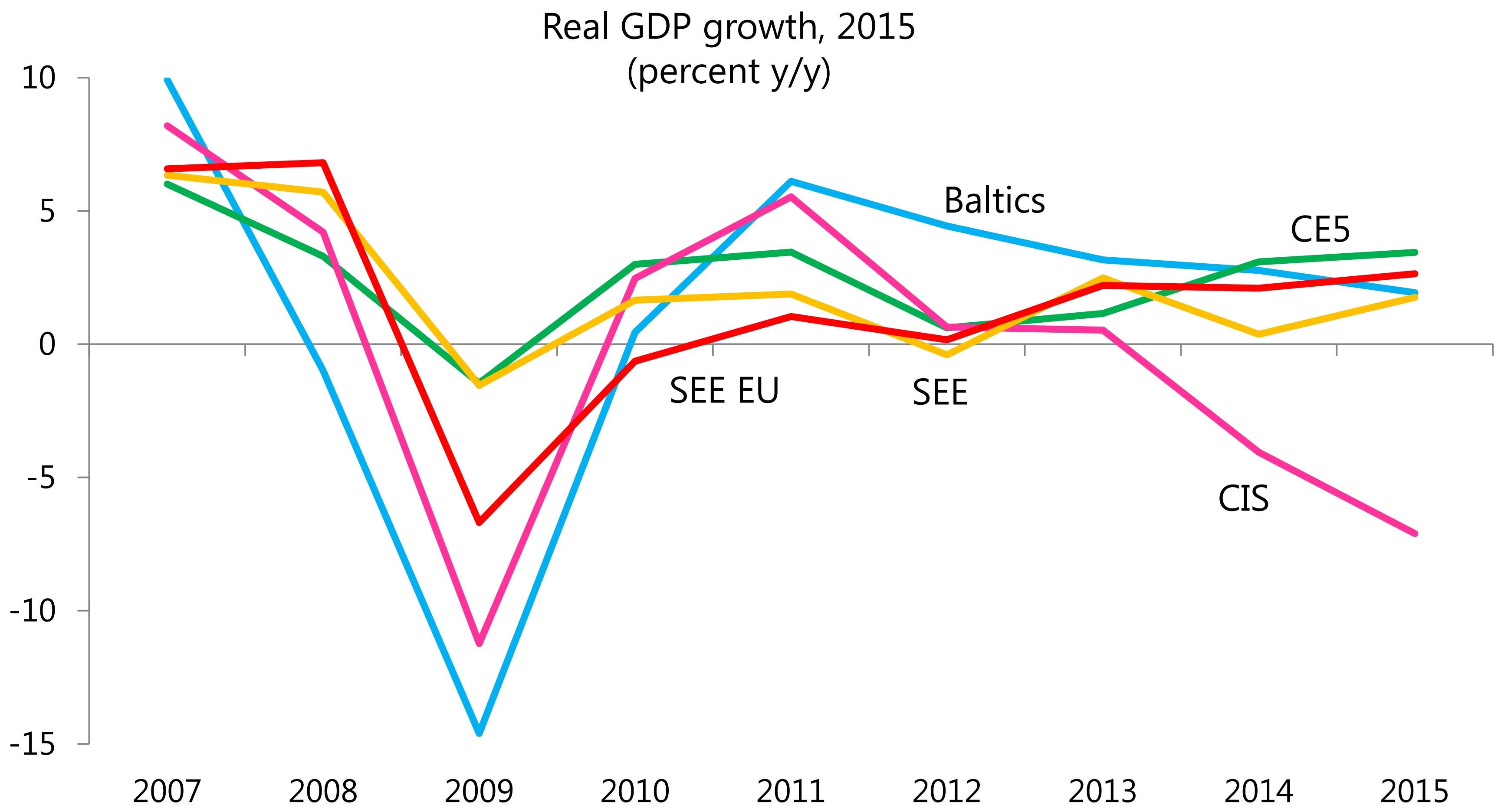
Precautionary programs

In second half of 2009, risk aversion declined sharply

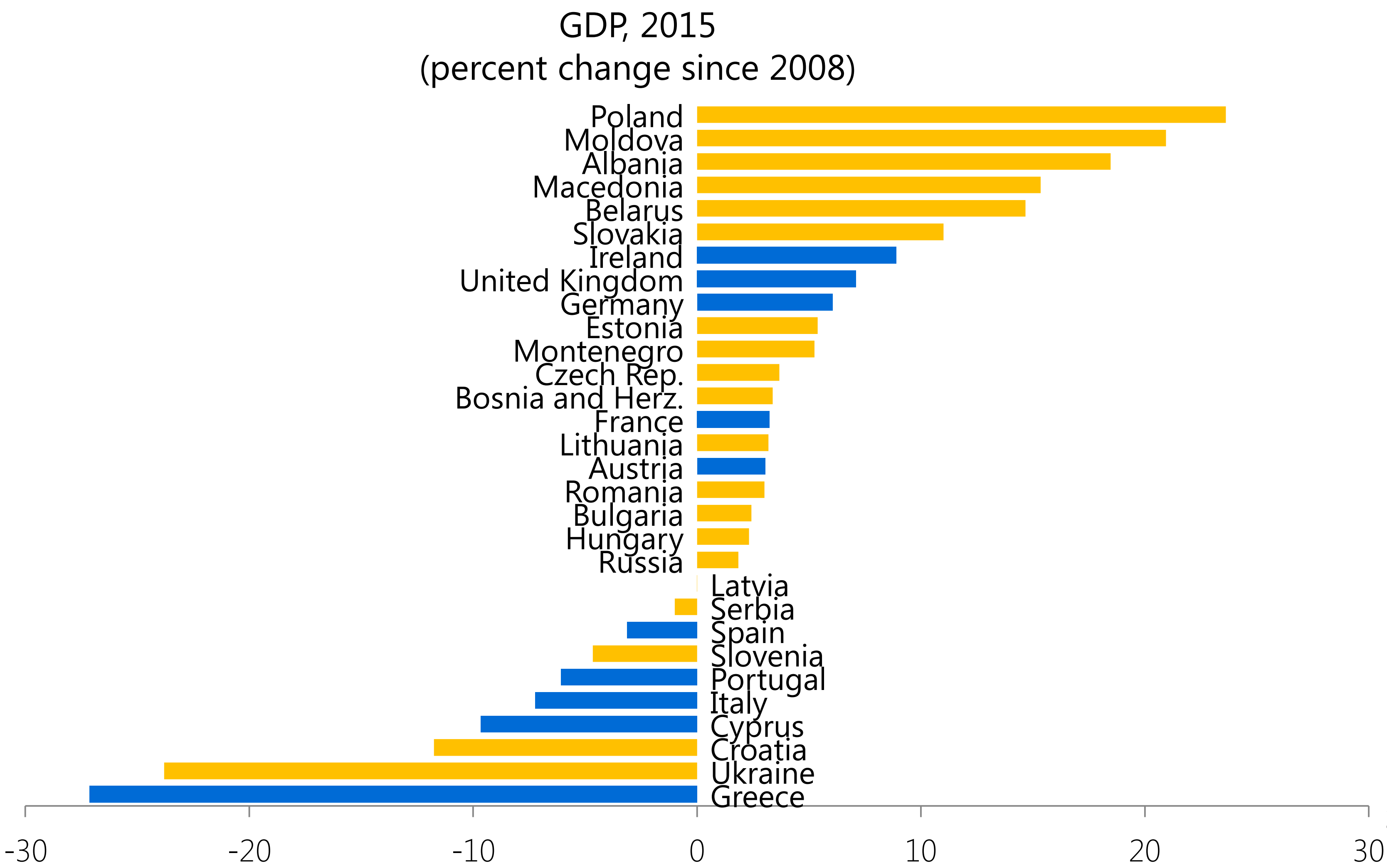




In 2010, region started to grow again

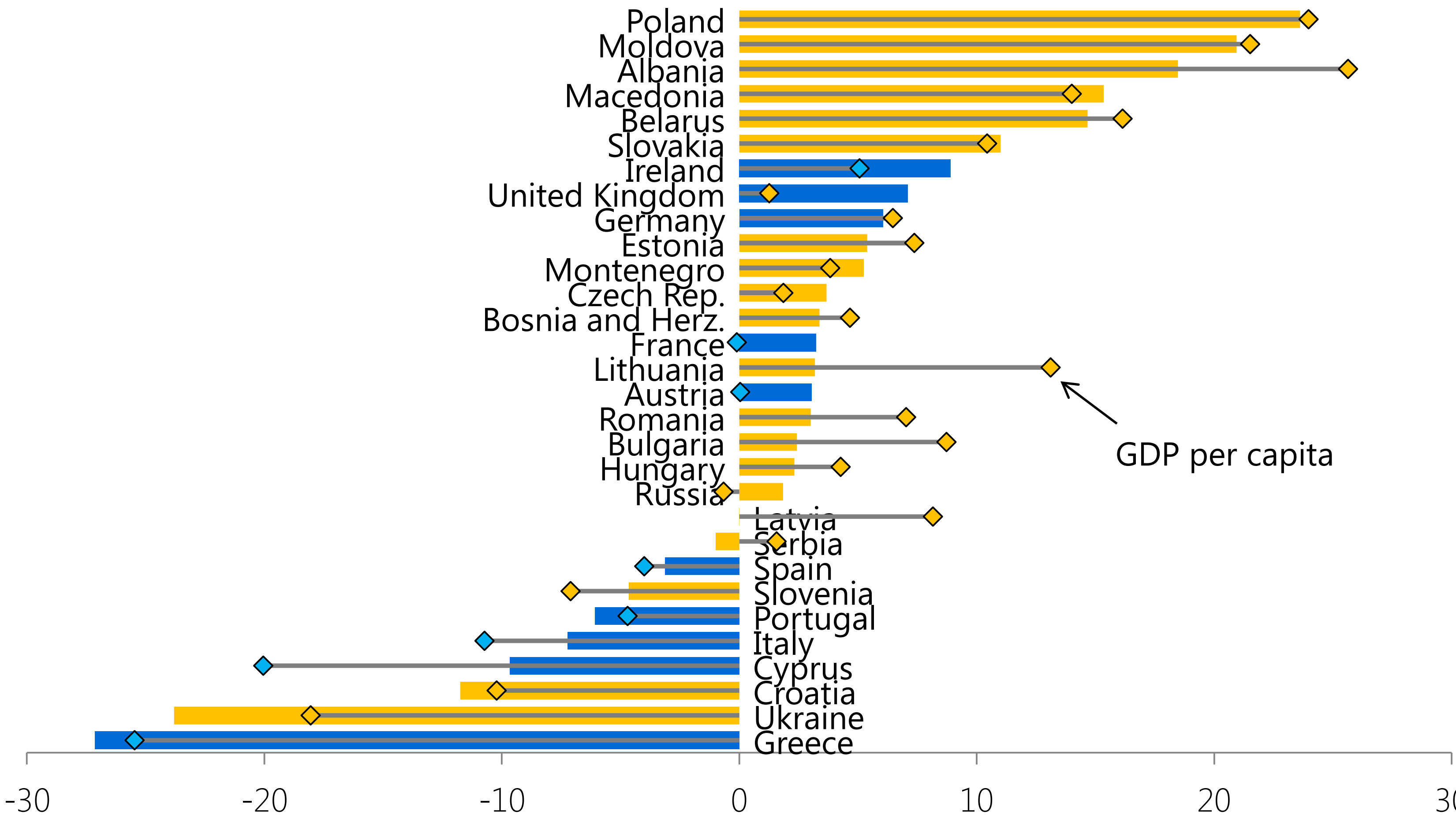


The crisis was deep, but most countries have recovered to above pre-crisis levels (unlike the euro area periphery)



In per capita terms, growth has been faster—although of course tepid by pre-crisis standards

GDP and GDP per capita, 2015
(percent change since 2008)



Fiscal policy during the crisis

The boom-bust was a *private-sector* phenomenon

- They were NOT the result of fiscal imbalances
  - (with the exception of Hungary)

- The boom was hard to stop
  - Countries took extensive macro-prudential measures
  - They did not stop the credit boom
  - They helped create buffers in the banking system

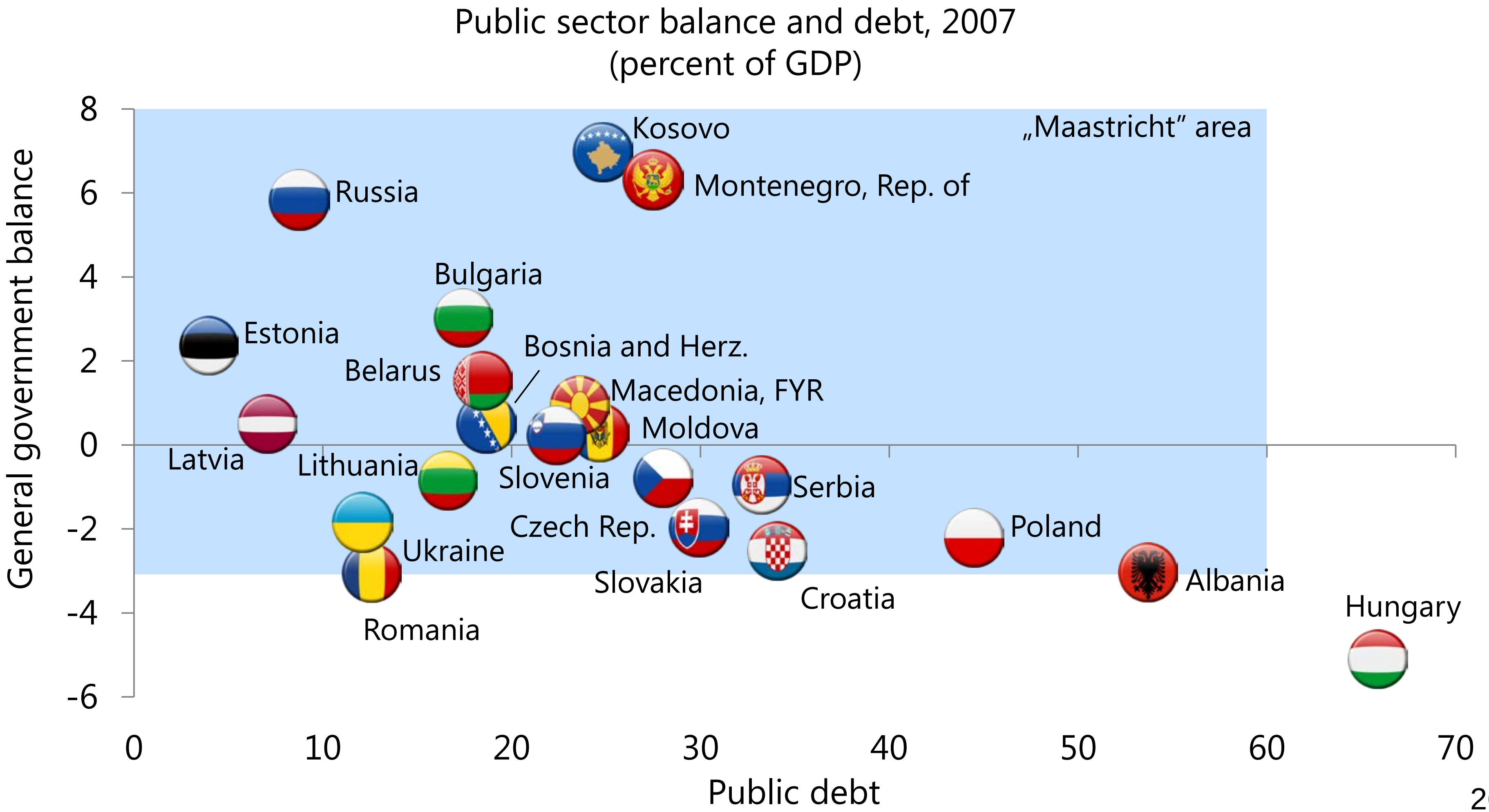
The boom would have been mitigated by rising risk premia

- Rising risk premia would have been automatic stabilizer (increased financing costs would have slowed credit growth)
- Problem was that risk premia *fell* during boom

Nevertheless, fiscal policy did *contribute* to the boom-bust

- Fiscal policy was very pro-cyclical:
  - Public expenditure grew very rapidly during the boom years
  - Fiscal policy was very contractionary during the bust.

During boom years most—but not all—countries had low debt and deficits

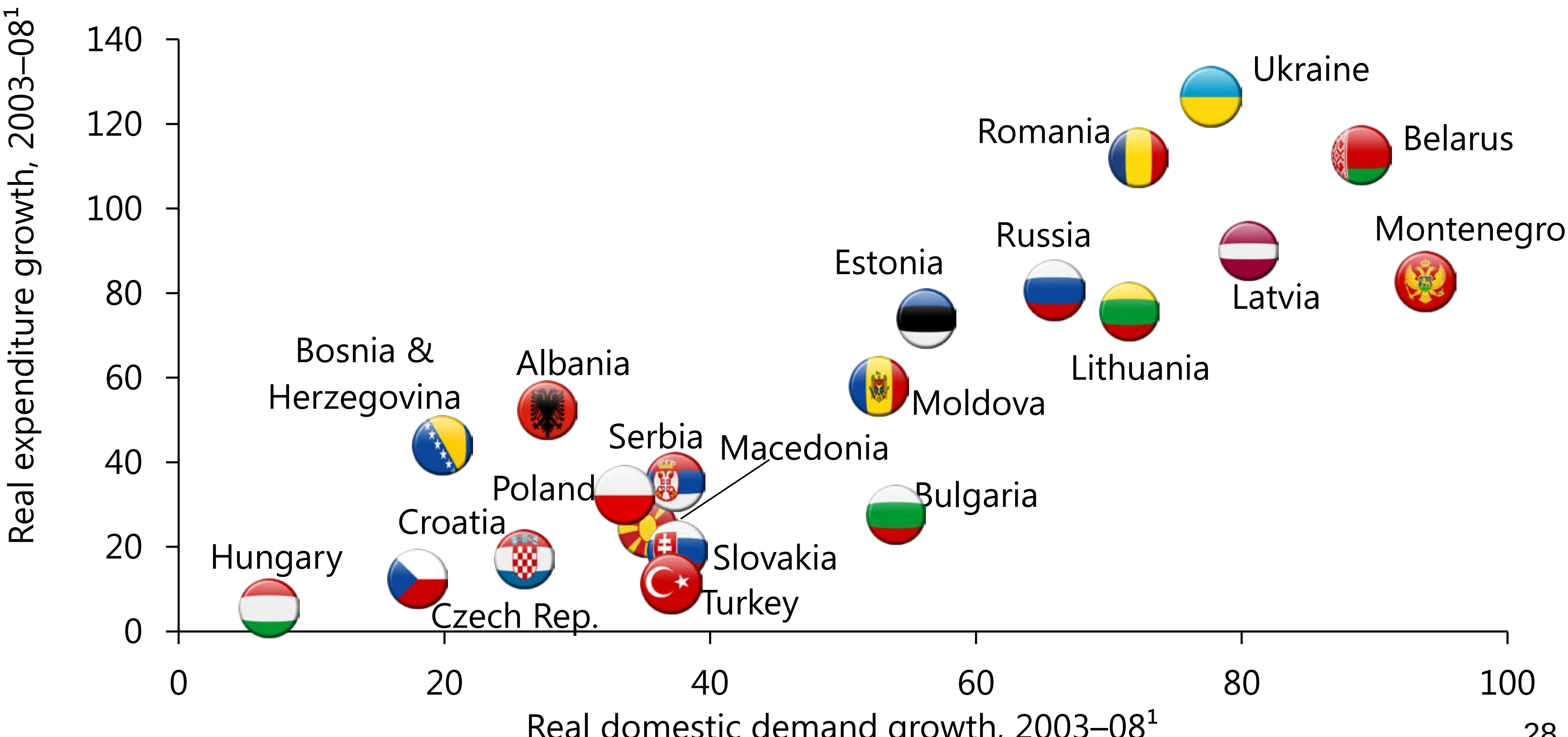


However, public expenditure was growing rapidly

- Domestic demand boom led to public revenue boom
- Revenue boom led to public expenditure boom
  - Unfortunately, much of the revenue boom turned out to be temporary
  - While the increase in expenditure had a more permanent character.

Thus, in countries where private demand grew rapidly, public demand did so too.

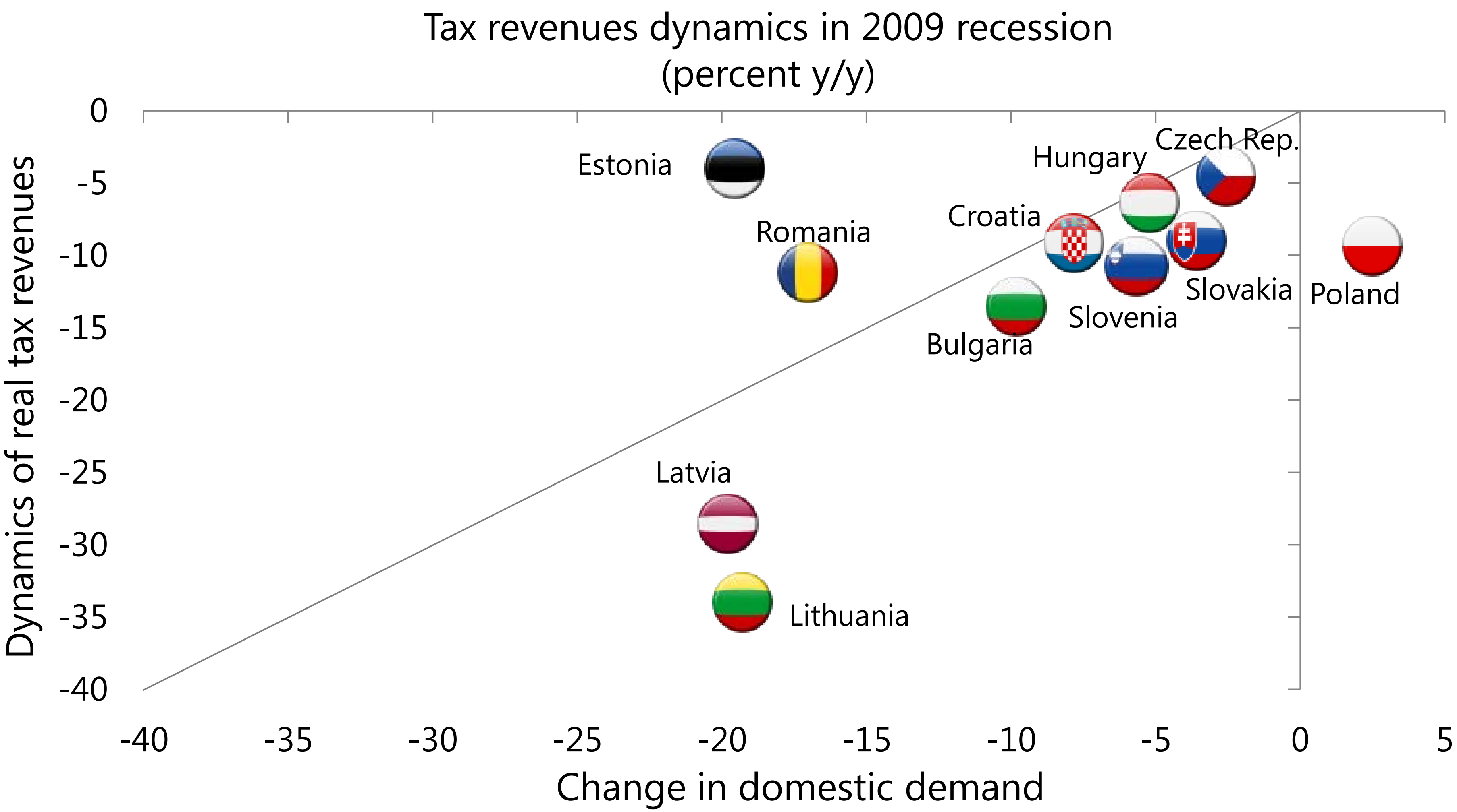
Domestic demand and government expenditure during the boom years



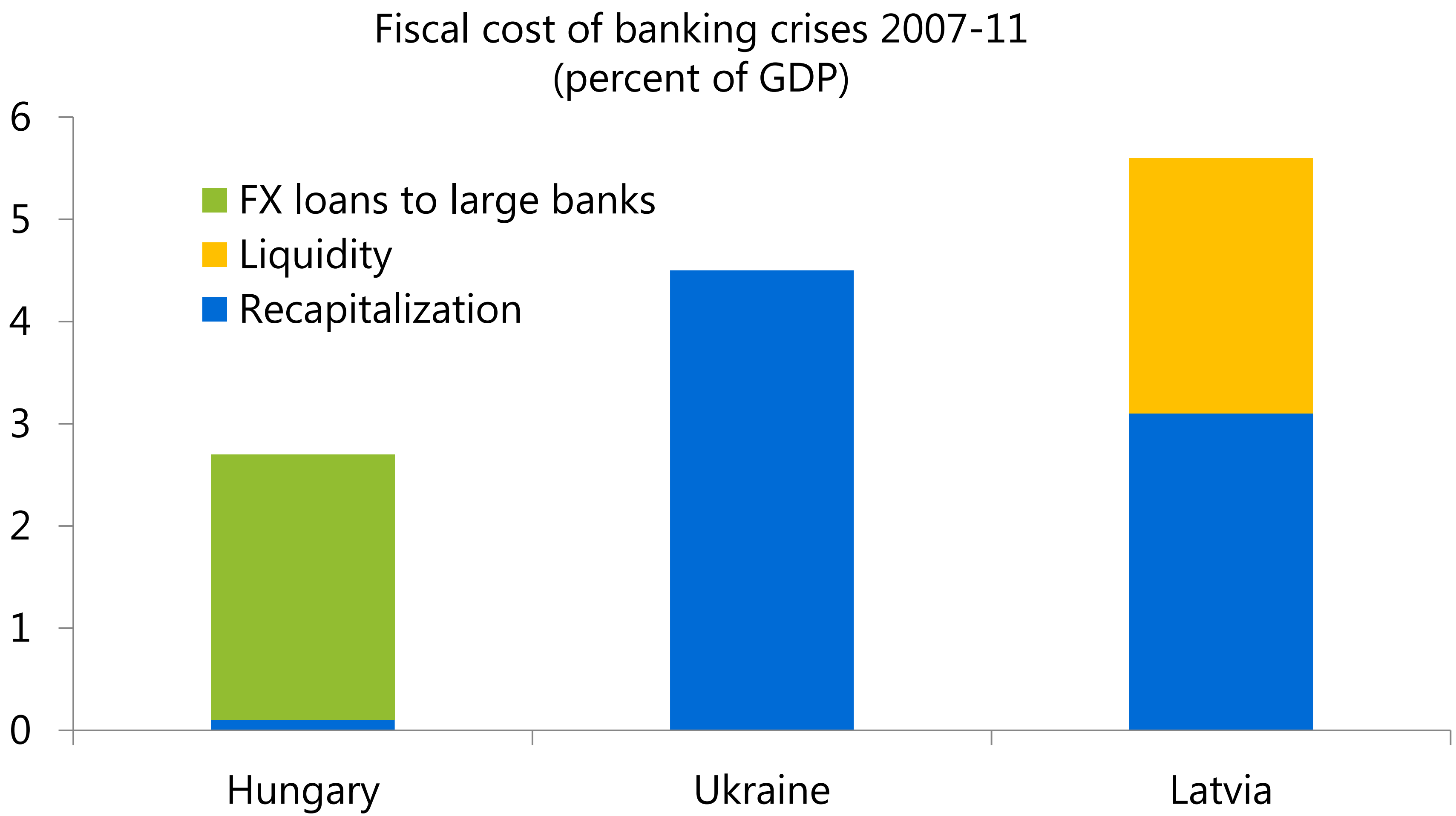
Example: Bulgaria

- Bulgaria: 3 percent surplus in 2007 and 2008→looks very prudent
- Revenue increased by 30 percent in 2008→so did expenditure!

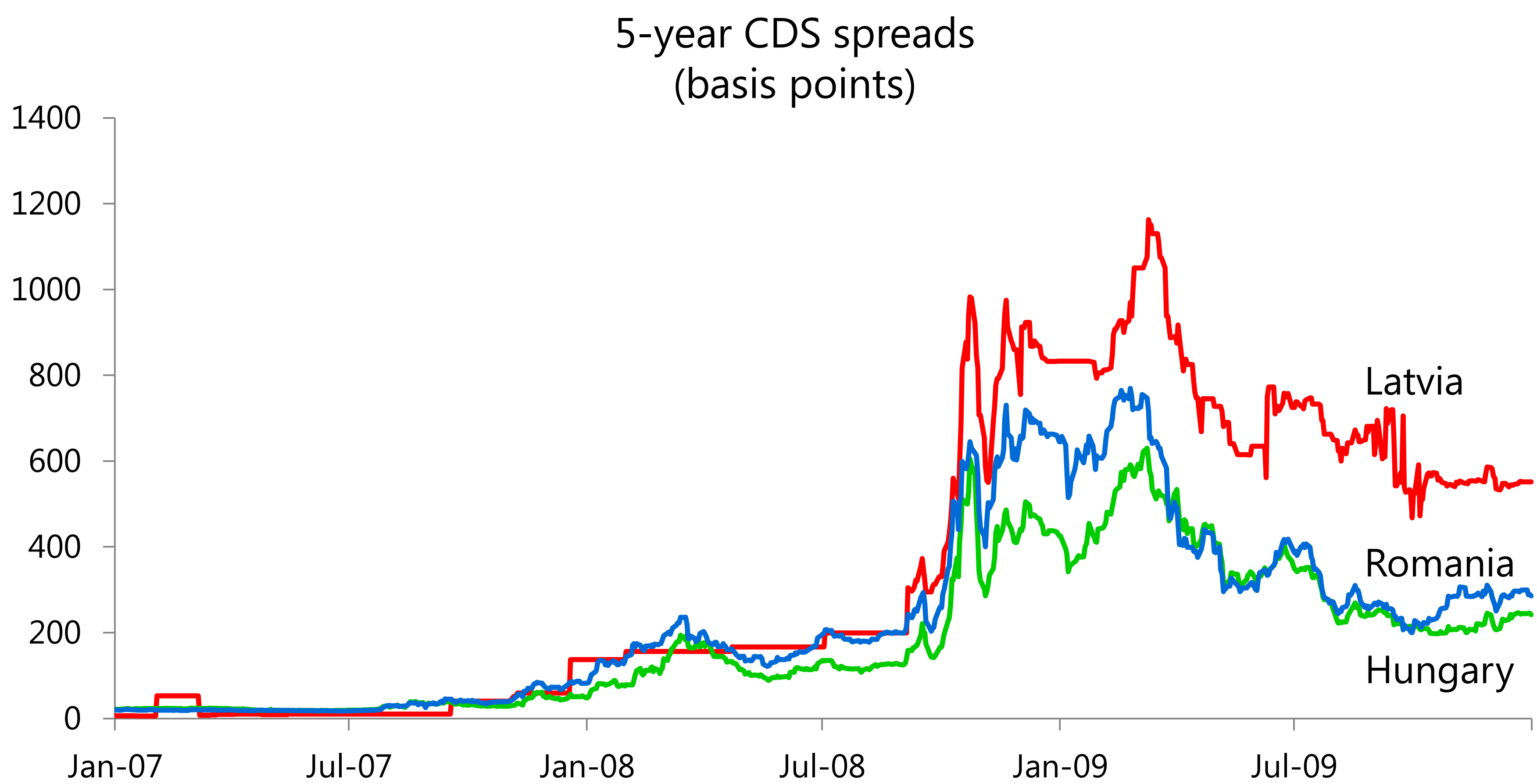
The end of the domestic demand boom led to a sharp decline of revenue…



Financial sector support further added to fiscal pressures.



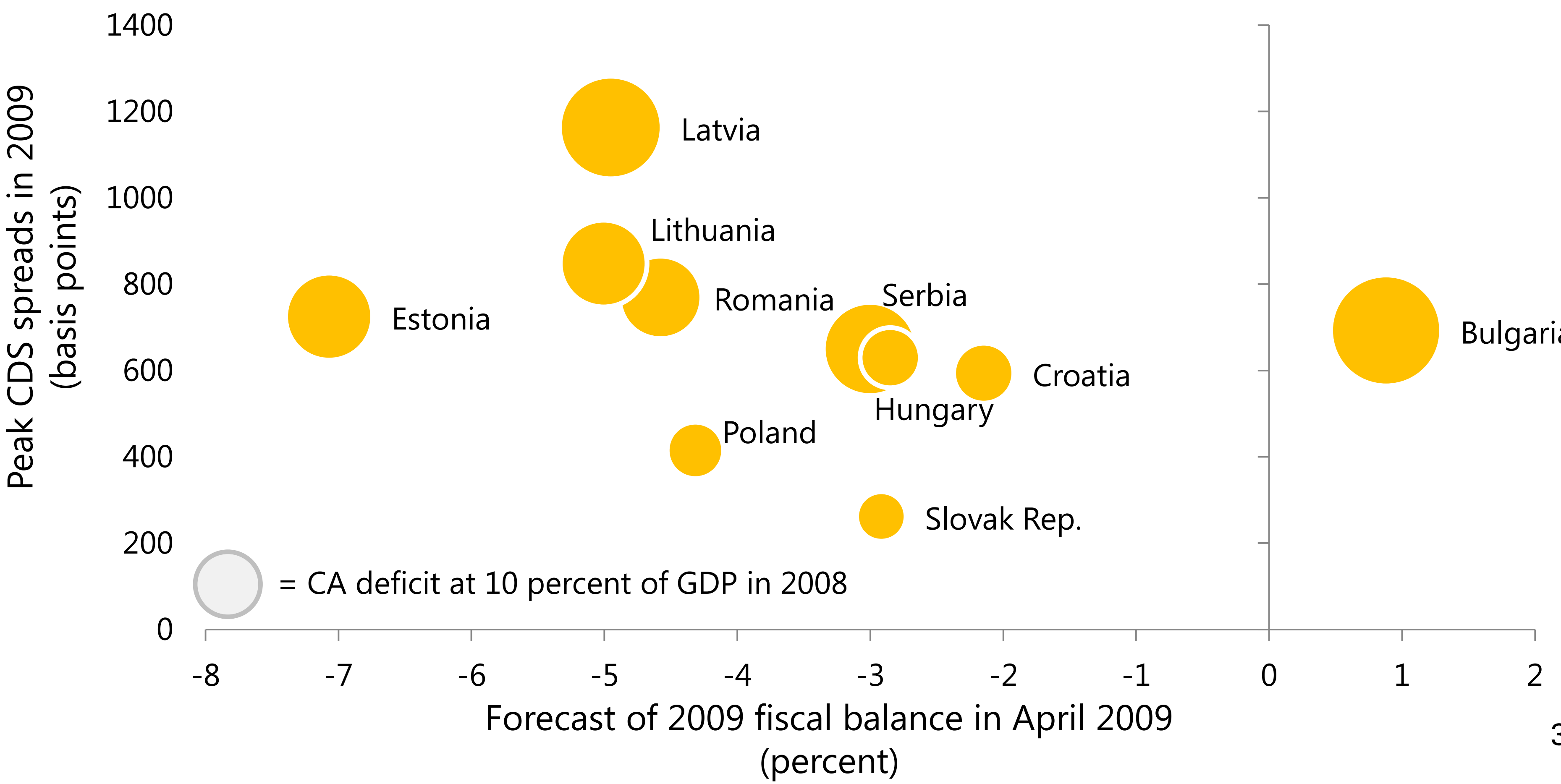
Risk premia rose sharply



Note: 5-yr CDS spreads at 600 basis points translate into 10 percent probability of default over the next 5 years, assuming 40 percent recovery rate.

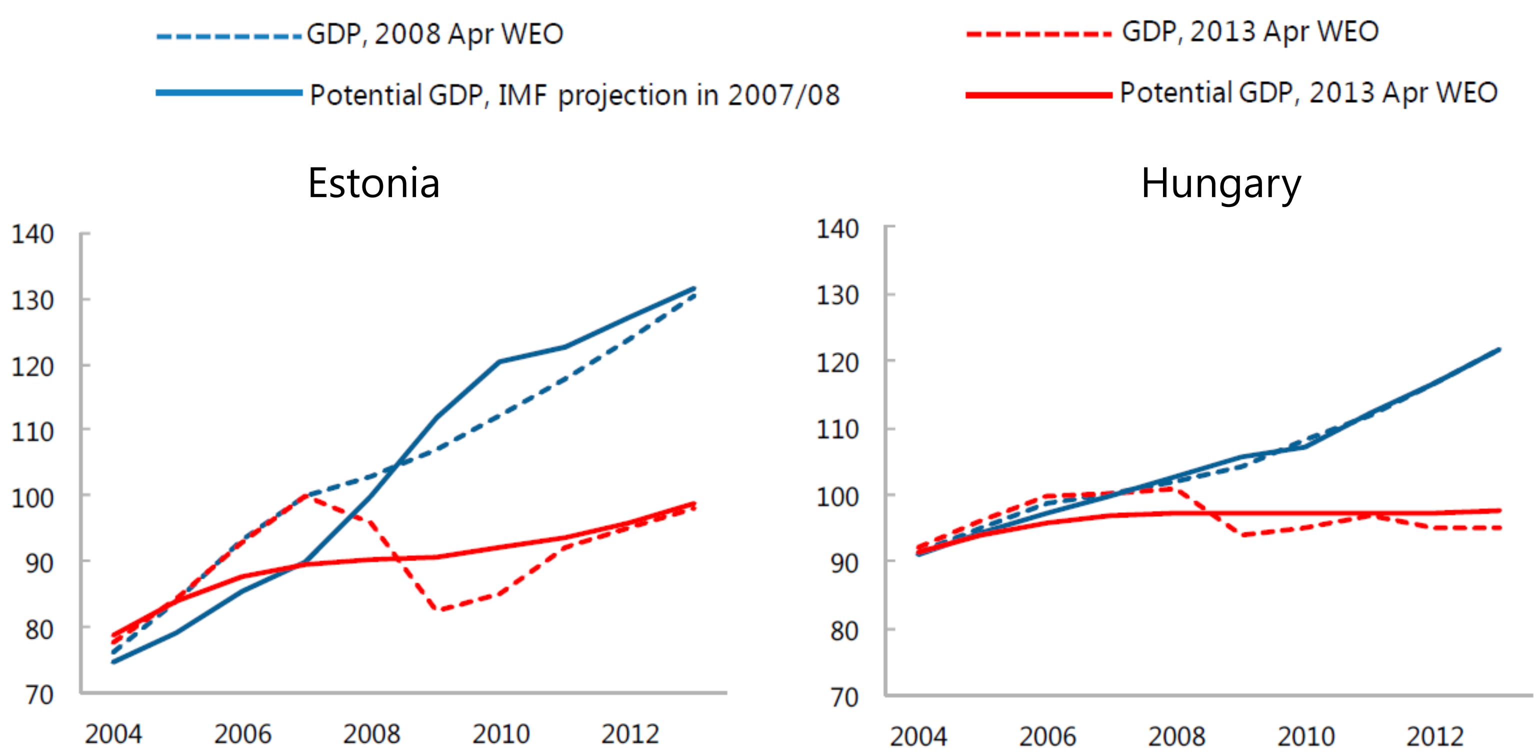
Particularly in countries with high projected deficits

Imbalances and 5-year CDS spreads

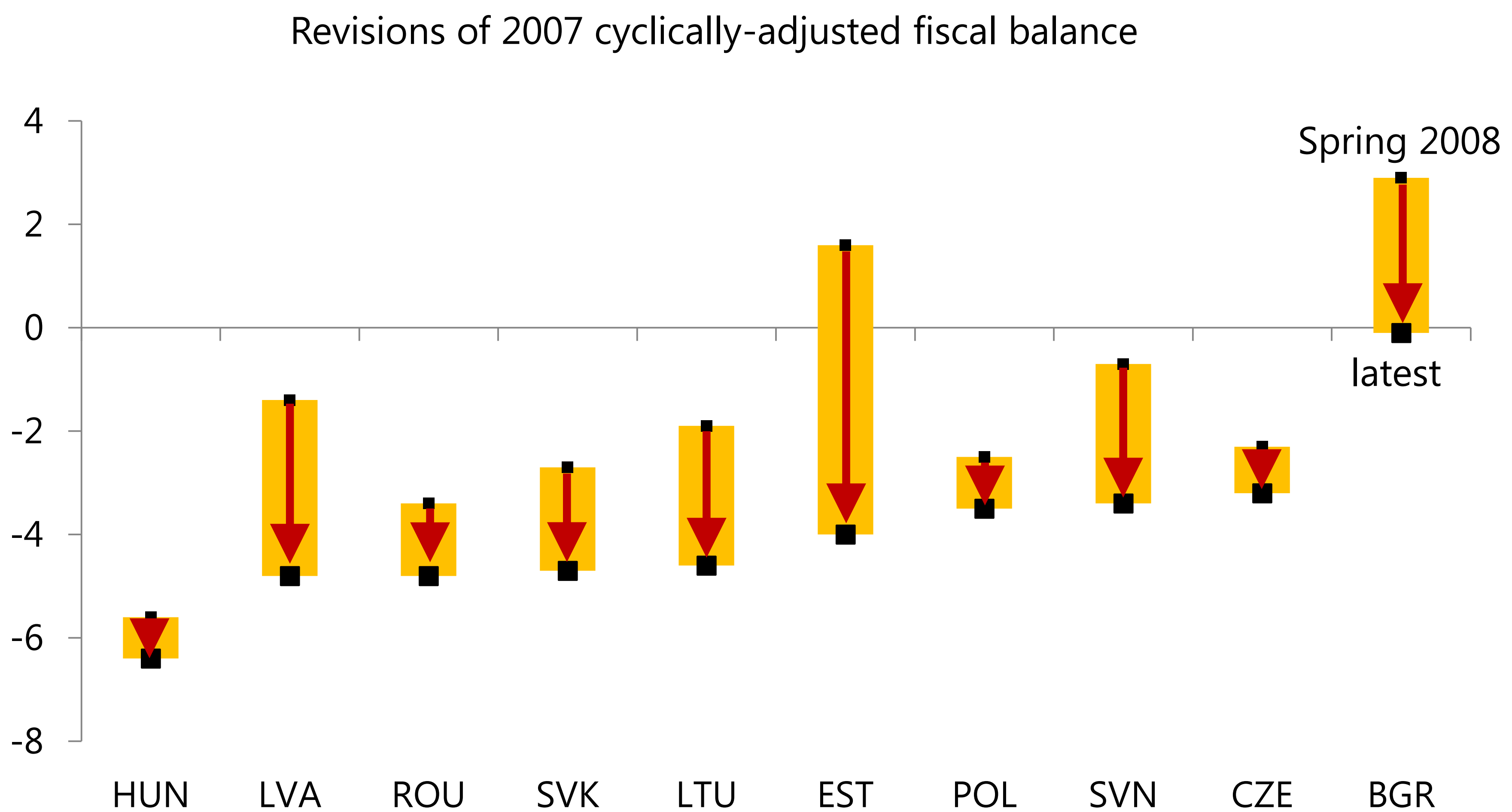


Projections of potential output were revised sharply as well…

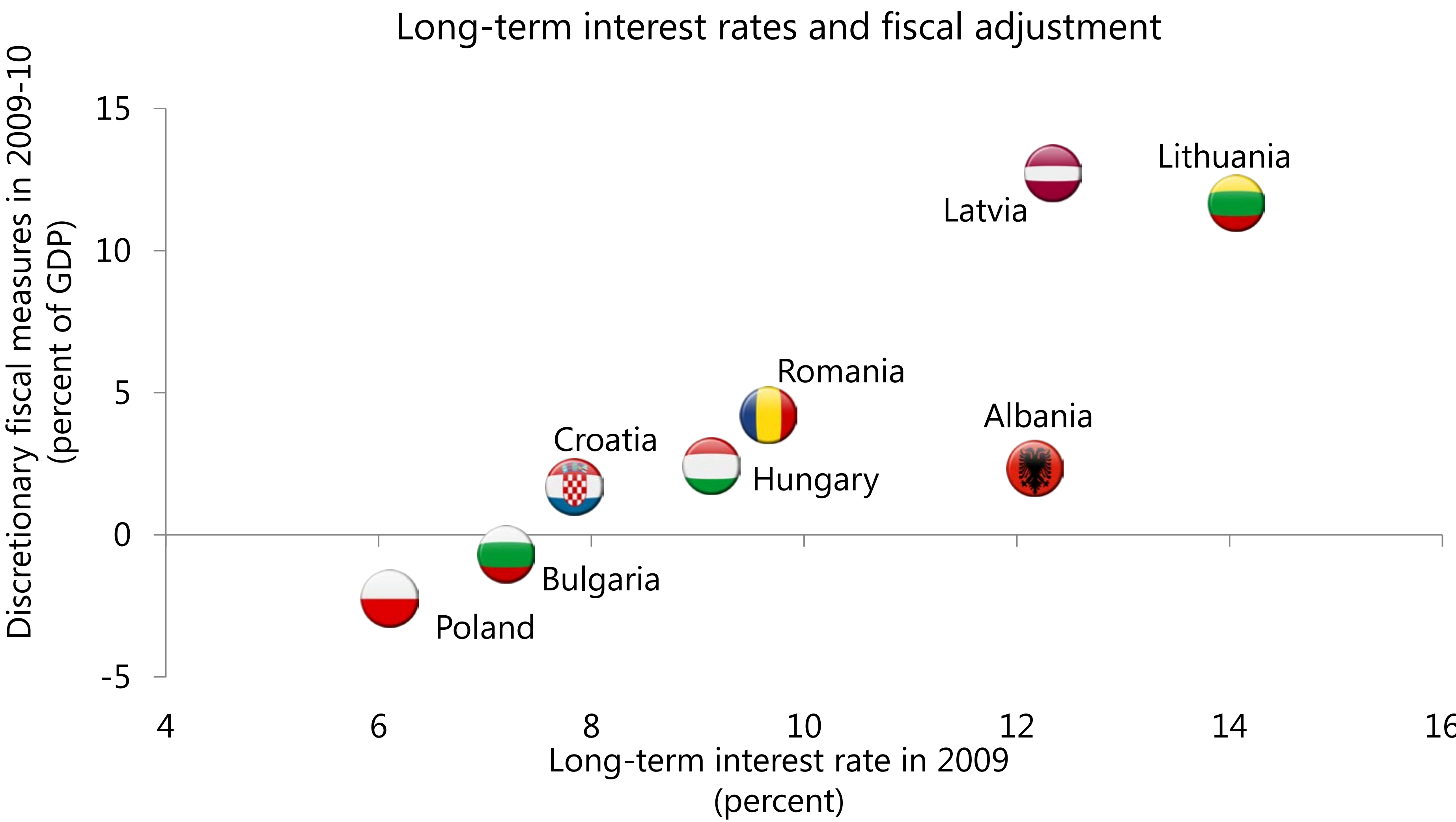
Estimates of Real and Potential GDP
(index, real GDP in 2007=100)



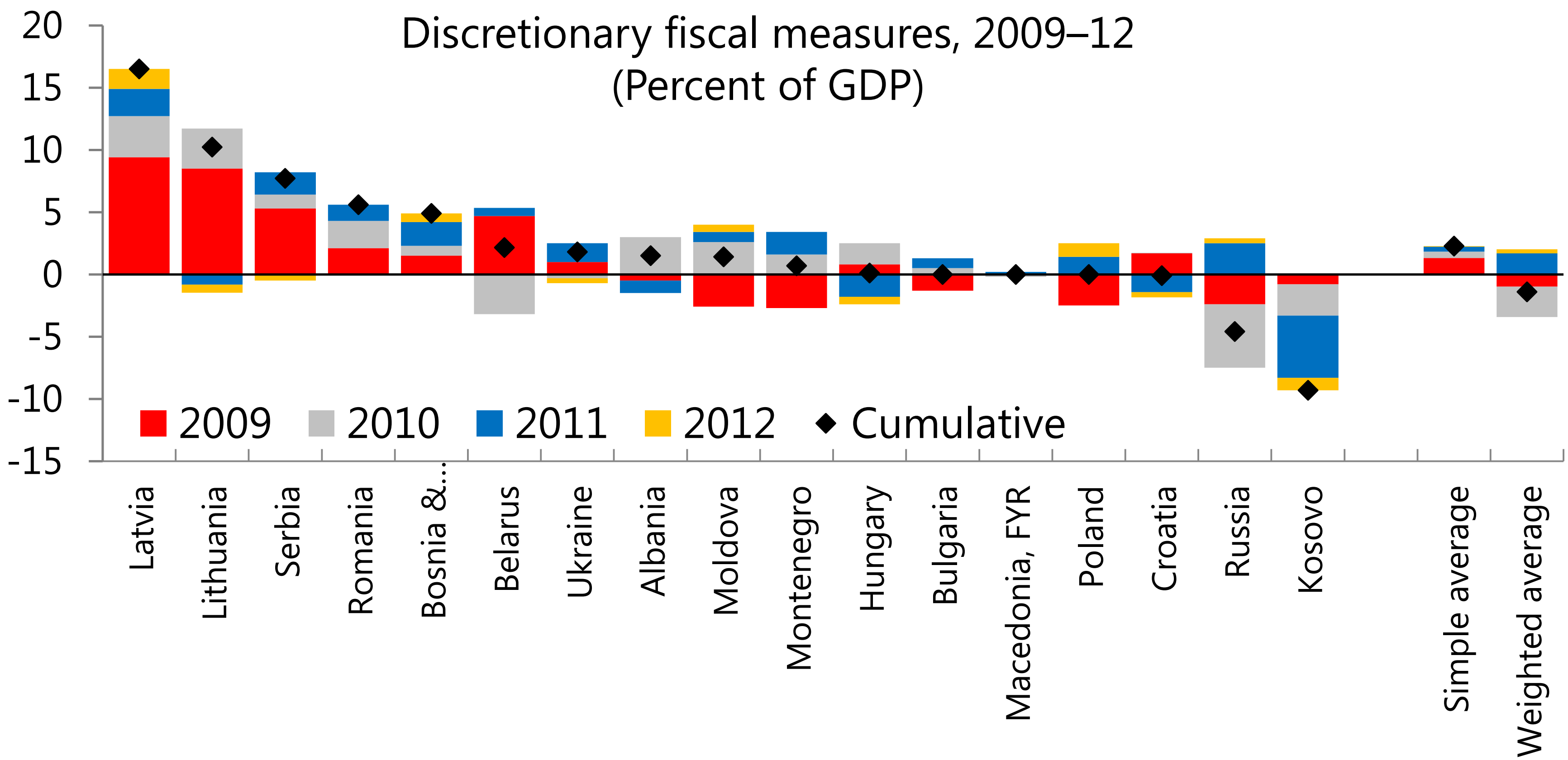
And estimates of pre-crisis structural deficits were increased sharply



Strong financial pressures led to upfront adjustment.

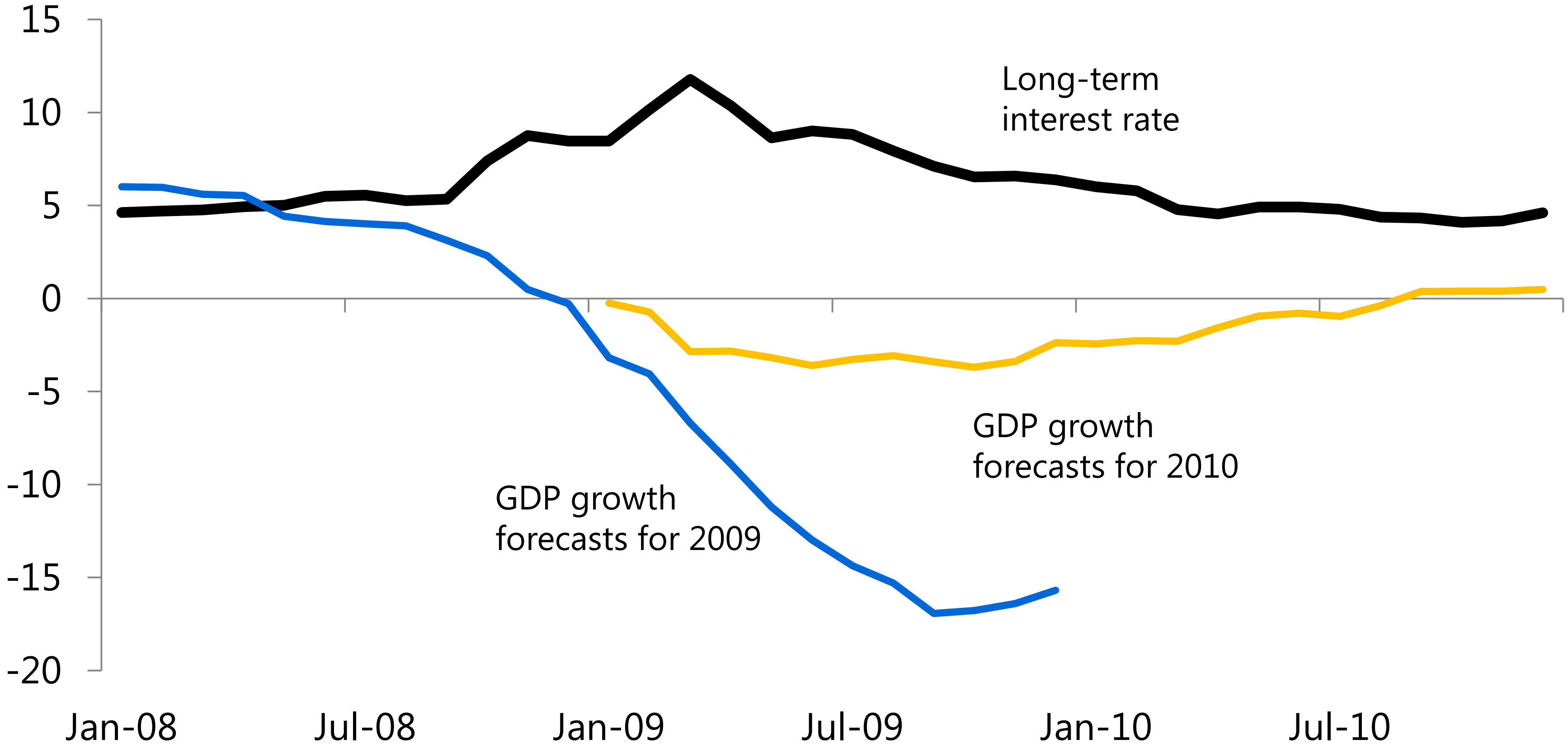


Some countries took very strong measures to contain rise in deficits



Interest rates declined subsequently; recovery followed

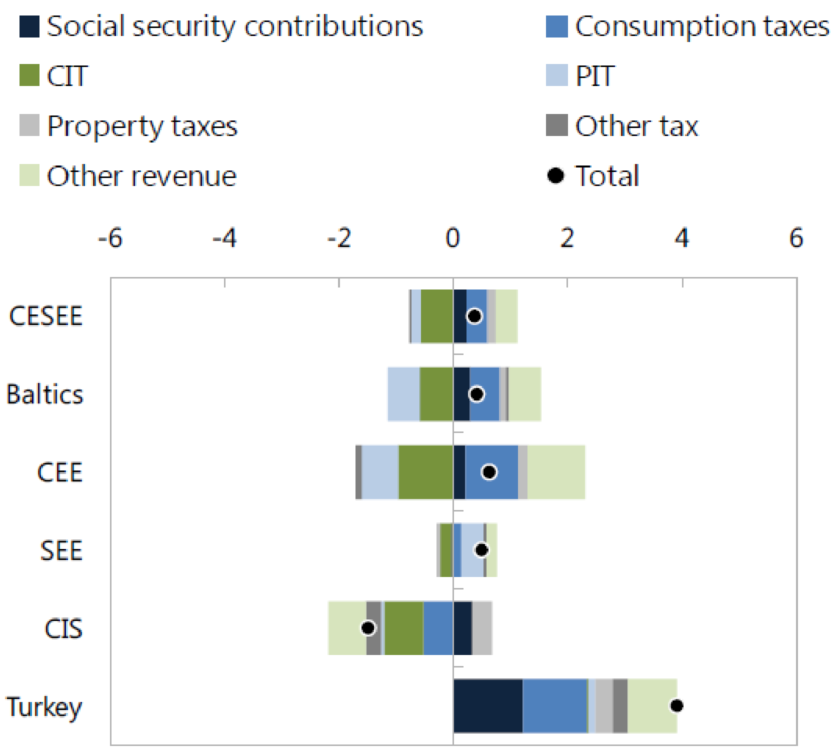
Interest rates and growth prospects in Lithuania, 2008-10



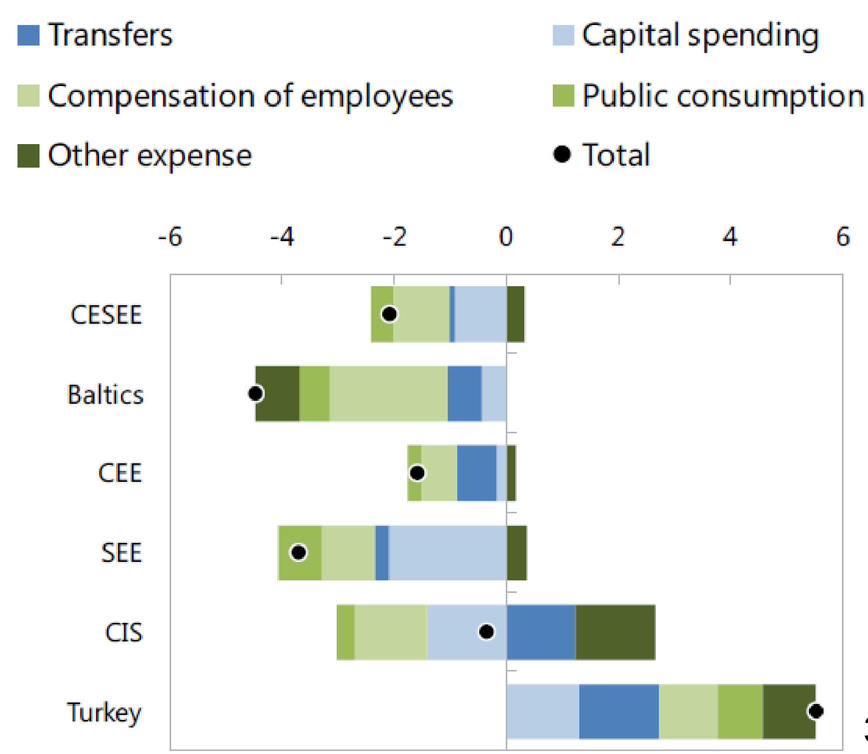
Both revenue and expenditure contributed to deficit reduction

Changes in budget structures, 2008-14
(percent of potential GDP)

Revenue changes

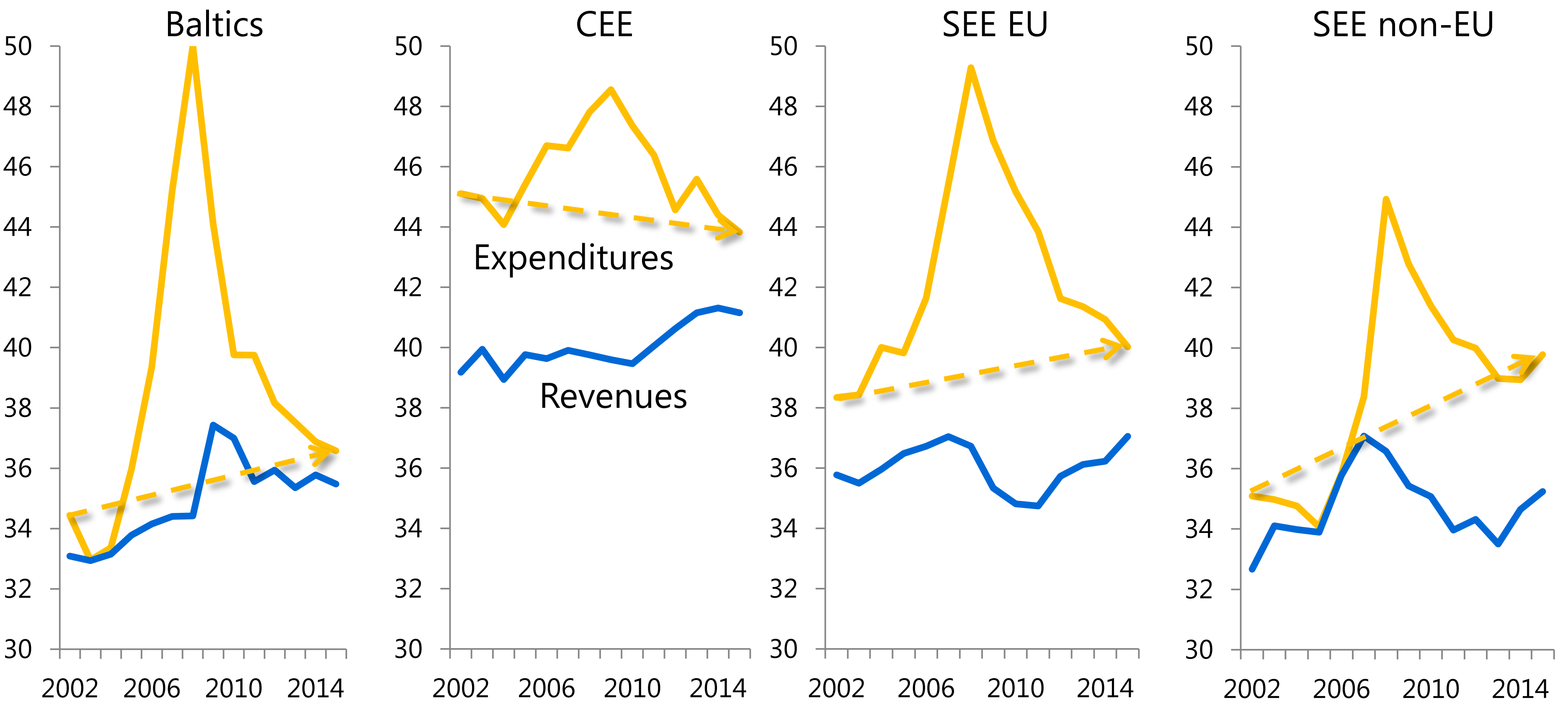


Expenditure changes



Expenditure to GDP ratios have come down from crisis-peak—but are not yet back to pre-crisis levels

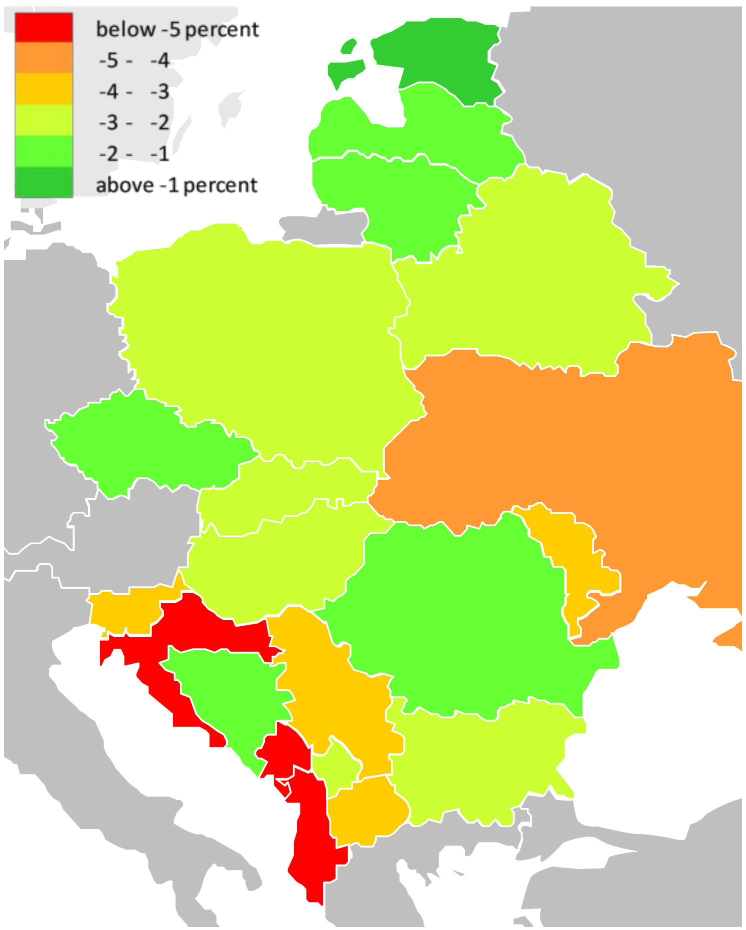
Revenues and expenditures as percent of trend GDP 2002-15



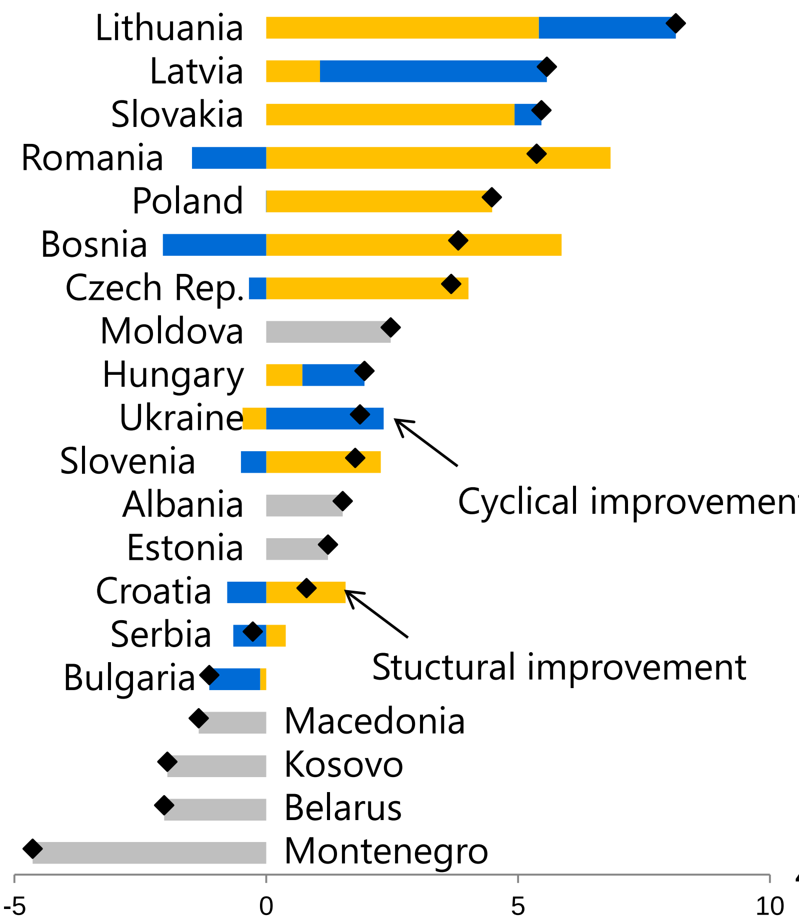
Note: Averages are unweighted.

Fiscal deficits have declined to more modest levels…

Fiscal balance
(percent of GDP)

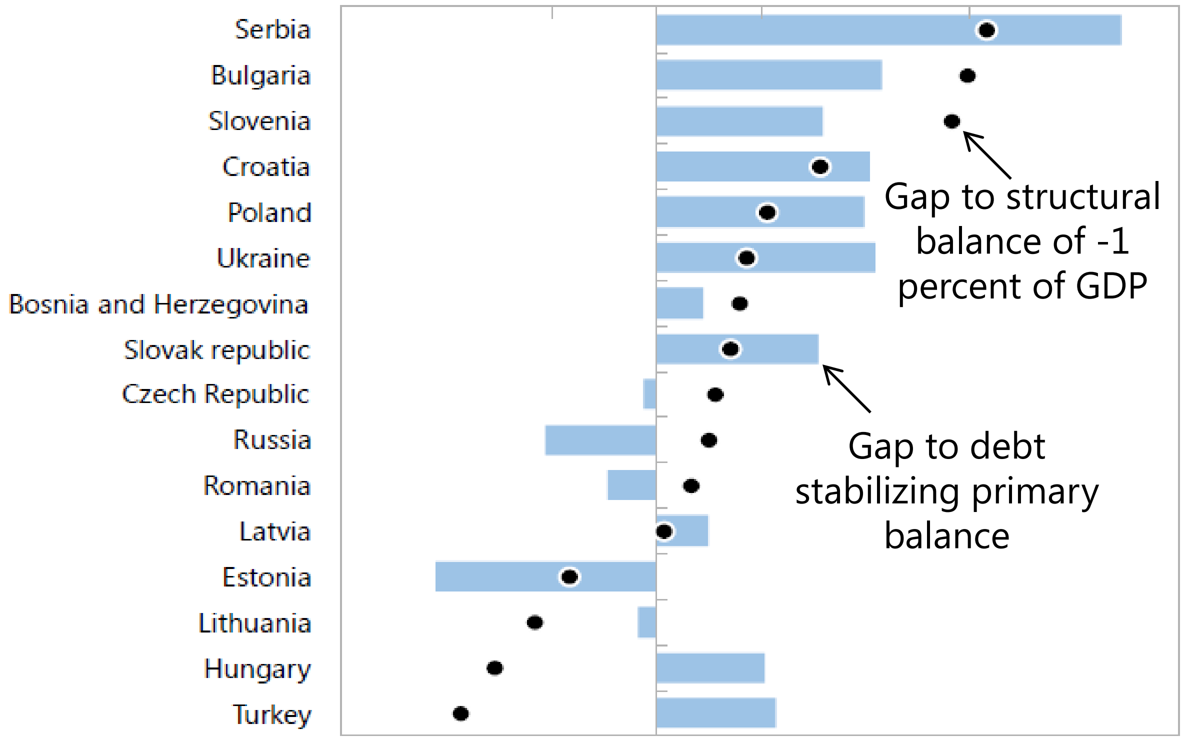


Change in fiscal balance, 2009-15
(percent of GDP)



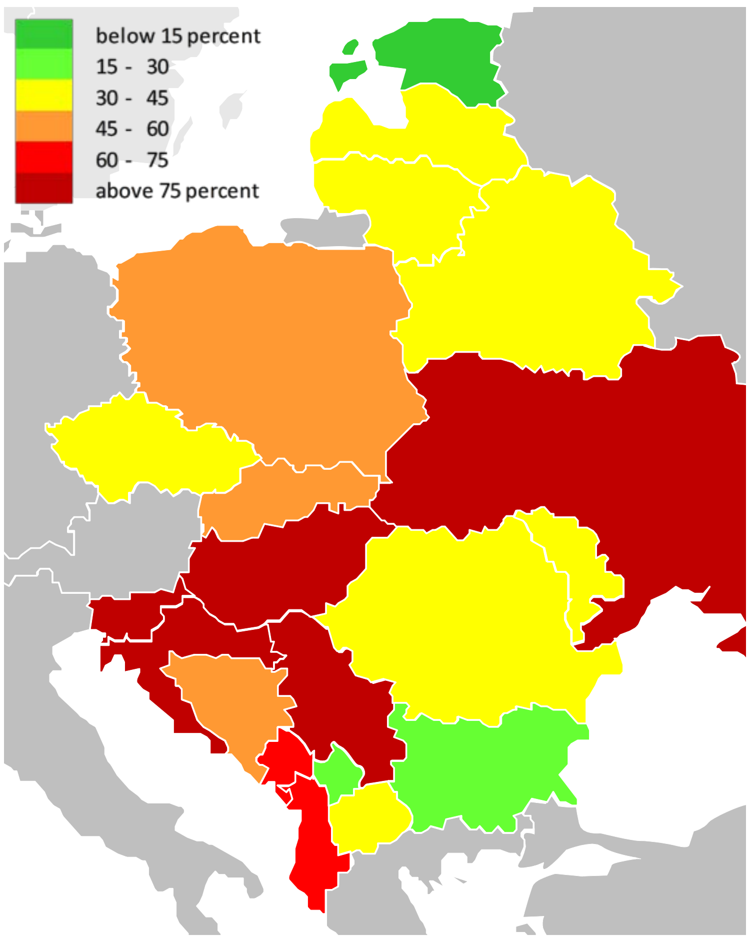
...but adjustment is not yet over.

Estimated remaining adjustment needs
(percent of GDP)

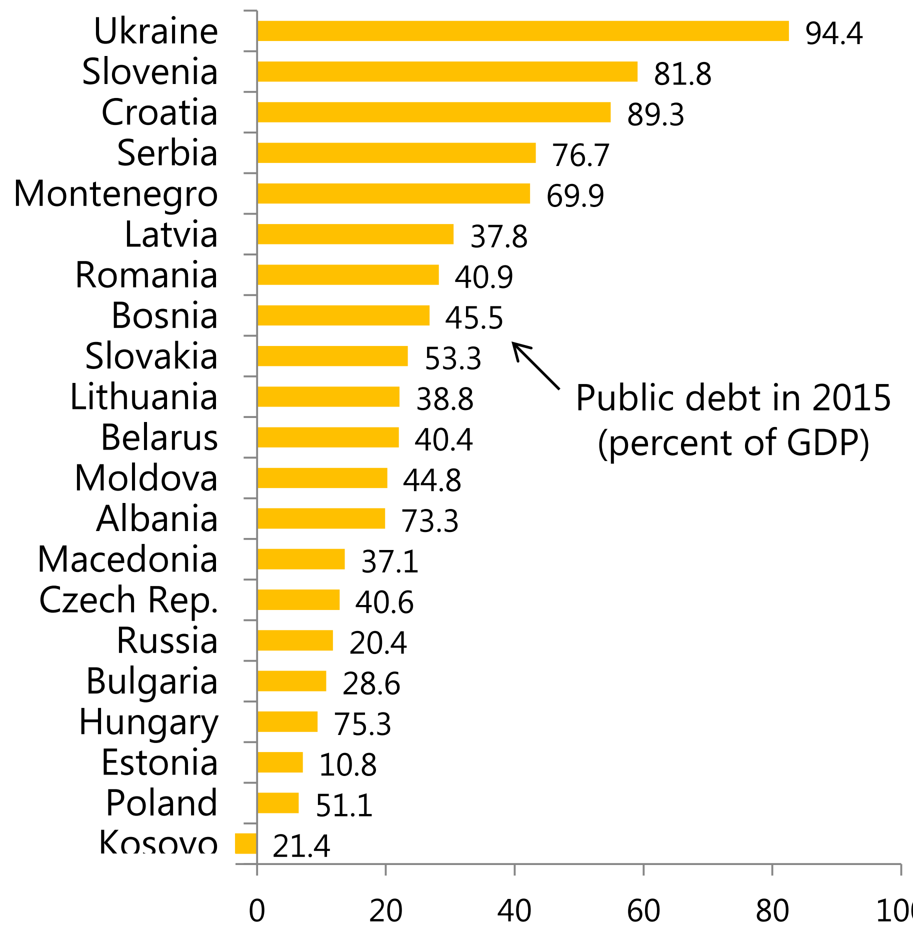


And public debt is no longer low

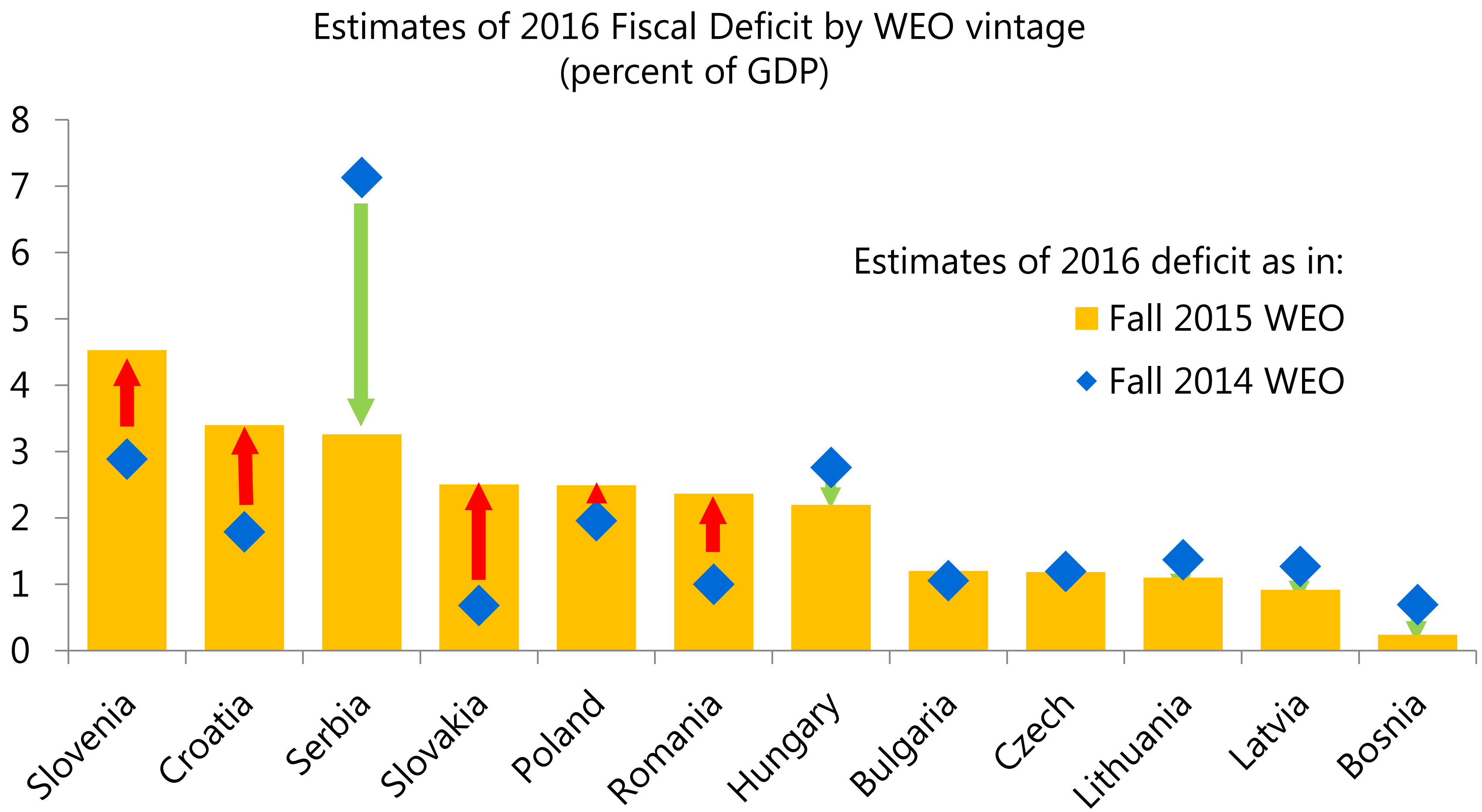
Public debt
(percent of GDP)



Change in public debt, 2007-15
(percent of GDP)



However, adjustment fatigue seems to have set in.



Concluding thoughts

- The crisis in CESEE was in most countries a *private sector* boom-bust
- However, fiscal policy exacerbated the boom-bust
  - During the boom, expenditure grew too rapidly, fueling overheating
  - Temporary revenue boom was used for permanent increase in expenditure
  - As a result, countries were forced to do fiscal adjustment in the midst of the crisis

Lessons for future crises

- If you want to use fiscal policy during a bust, you need to build up buffers during a boom
- When you have a very strong domestic demand boom, you may need to build up very large fiscal surpluses during good time, if you want to let stabilizers work during busts

But is that feasible?

- Question: can you run 5 percent of GDP—or more surpluses?
- Can you recognize unsustainable booms in time?

What do you when there is a boom?

- Ask yourself where the boom is coming from and target the measures at the sources of the boom.
- Bear in mind that you may never get this right and, therefore, having some fiscal space in reserve is critical.

Most important lesson!

- Booms never last!
  - However, they last longer than you think
  - *When* they end, the crisis comes much faster than you think
- Be skeptical when someone tells you that “this time is different”

Thank you