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

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Bas B. Bakker
Senior Regional Resident Representative for Central and Eastern Europe
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)

- Slovenia
- Czech Rep.
- Estonia
- Slovakia
- Hungary
- Lithuania
- Latvia
- Croatia
- Russia
- Poland
- Romania
- Bulgaria
- Montenegro
- Belarus
- Serbia
- Macedonia
- Ukraine
- Bosnia
- Albania
- Moldova

2002
Convergence 2002-07
...fueled by strong capital inflows.

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

- Portfolio
- FDI
- Other, including banks
- Total

*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.
Bank flows fueled a credit boom...

Change in external position of western banks and in private sector credit

Change in ratio of external position of western banks to GDP, 2003–08
... which boosted domestic demand.
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

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

Real expenditure growth, 2003–08

Real domestic demand growth, 2003–08
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...

**Tax revenues dynamics in 2009 recession (percent y/y)**

- Estonia
- Latvia
- Lithuania
- Romania
- Bulgaria
- Croatia
- Hungary
- Slovenia
- Slovakia
- Czech Rep.
- Poland

**Change in domestic demand**

-40 -35 -30 -25 -20 -15 -10 -5 0 5

**Dynamics of real tax revenues**

-40 -35 -30 -25 -20 -15 -10 -5 0 5
Financial sector support further added to fiscal pressures.

Fiscal cost of banking crises 2007-11 (percent of GDP)

- **Hungary**
  - FX loans to large banks
  - Liquidity
  - Recapitalization

- **Ukraine**
  - Recapitalization

- **Latvia**
  - Recapitalization
  - Liquidity
Risk premia rose sharply

5-year CDS spreads (basis points)

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.
Projections of potential output were revised sharply as well...

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

Estonia

Hungary
And estimates of pre-crisis structural deficits were increased sharply

Revisions of 2007 cyclically-adjusted fiscal balance
Strong financial pressures led to upfront adjustment.

Long-term interest rates and fiscal adjustment

Discretionary fiscal measures in 2009-10 (percent of GDP)

Long-term interest rate in 2009 (percent)
Some countries took very strong measures to contain rise in deficits

Discretionary fiscal measures, 2009–12
(Percent of GDP)
Interest rates declined subsequently; recovery followed.
Both revenue and expenditure contributed to deficit reduction

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

- Lithuania
- Latvia
- Slovakia
- Romania
- Poland
- Bosnia
- Czech Rep.
- Moldova
- Hungary
- Ukraine
- Slovenia
- Albania
- Estonia
- Croatia
- Serbia
- Bulgaria
- Macedonia
- Kosovo
- Belarus
- Montenegro
...but adjustment is not yet over.

Estimated remaining adjustment needs (percent of GDP)

Gap to structural balance of -1 percent of GDP

Gap to debt stabilizing primary balance
And public debt is no longer low

Public debt (percent of GDP)

Public debt in 2015 (percent of GDP)

Ukraine: 94.4%
Slovenia: 81.8%
Croatia: 89.3%
Serbia: 76.7%
Montenegro: 69.9%
Latvia: 37.8%
Romania: 40.9%
Bosnia: 45.5%
Slovakia: 53.3%
Lithuania: 38.8%
Belarus: 40.4%
Moldova: 44.8%
Albania: 73.3%
Macedonia: 37.1%
Czech Rep.: 40.6%
Russia: 20.4%
Bulgaria: 28.6%
Hungary: 75.3%
Estonia: 10.8%
Poland: 51.1%
Kosovo: 21.4%
However, adjustment fatigue seems to have set in.

Estimates of 2016 Fiscal Deficit by WEO vintage (percent of GDP)

Estimates of 2016 deficit as in:
- Fall 2015 WEO
- Fall 2014 WEO
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