

Part IV

Fiscal challenges during convergence in the recently acceded Member States

Summary

The Member States that joined the EU in May 2004 are at different stages in catching-up toward average EU levels of income and financial development. Fiscal policy can make a key contribution in this process through efficient tax and expenditure policies and also through helping to stabilize the economy. Over the long run, these two roles are complementary. Strong growth enhances the economy's debt-carrying capacity, while stability is crucial for sustainable catching up. In the short run, though, policy-makers in the recently acceded Member States may face difficult choices. Spending more on infrastructure, training or R&D can make it harder to contain deficits; and tax and pension reforms involve up-front costs. In many cases, such costs can be offset by restructuring existing programs in ways that benefit growth – reducing subsidies and streamlining administration; and preliminary analysis suggests significant scope for such restructuring in the new Member States that face major deficit challenges. Moreover, the EU makes a significant contribution through the structural funds.

Still, there can be tensions between financing priority programmes and safeguarding stability. Policy-makers in the new Member States have to make case-by-case judgements on priorities, taking into account of their differing economic and financial circumstances – stages in economic catching up, the structure of the public finances, and plans for adopting the euro. In terms of such specifics, fiscal challenges in all of the recently acceded Member States except Cyprus and Malta have been dominated by the transition from central planning. This left the Baltic states and most central European Member States with far to go in catching up toward EU living standards, and their economies have also been somewhat more volatile as a result. The most sweeping challenges of transition are over, but there are still sources of volatility ahead. It will be important to ensure room to cope with shocks to the economy when setting medium-term fiscal goals.

A relevant feature in most of the new Member States is that the financial sector is now expanding rapidly,

following crises and reforms in the 1990s. This deserves special attention in assessing the environment for fiscal policy. Healthy growth in credit is a key support for catching up; but it will be important to guard against excessively strong cycles in credit, asset prices, the external current account and the real exchange rate, which could misallocate resources and jeopardize stability. Banking supervision can play a valuable role here. And monetary policy, where free to address specifically domestic developments, can contribute by moderating inflationary booms and discouraging unhedged borrowing through exchange rate variability.

Fiscal policy can also contribute importantly to safeguarding stability at times when credit booms are underway, and when strong private investment causes the external current account deficit to widen. Here, varying experience in other Member States is informative. In some cases, policy-makers helped keep the economy stable by allowing strong booms to swing the budget towards smaller deficits or a surplus. That required care in not over-estimating the sustainable growth trend, and recognizing that strong tax gains might in part prove temporary. This helped to moderate booms, and provided a cushion when growth slowed down as a result of external shocks or retrenchment by households and firms. In some cases, periods of strong growth were used to speed up fiscal consolidation. Prudent fiscal policy in such cases helped complement and balance strong private sector expansion.

Should fiscal policy, during an extended boom, go further by temporarily running smaller deficits or larger surpluses than required for debt sustainability or the free play of stabilizers within the limits of the Maastricht Treaty? The case for this is less clear-cut than the need to avoid pro-cyclical easing. Some additional headroom could, however, be prudent if private sector exuberance is setting the stage for a crisis – for example, if the current account deficit widens so steeply as to threaten confidence. Should one-off adjustments become necessary, these can be costly if they fall on investment;

and policy lags mean that tightening may take effect just as the economy is slowing down.

This highlights the case for fostering stability in complementary ways. Notably, there is scope to foster stable expectations through transparent and credible medium-term frameworks, which are well-understood by markets and can help protect strategic tax and spending priorities. This is one way in which strong fiscal institutions can help improve the prospects for stability. It is also valuable to review microeconomic aspects of policy, such as distortions resulting from subsidies to real estate credit.

All of the new Member States need to take account of a further element in the environment for fiscal policy: actual and planned monetary and exchange regimes. This is evident from recent experience. In the Baltic states hard currency pegs have been underpinned by goals of budget balance and low levels of public debt, while in most central European economies flexible exchange rates are associated with higher deficits and debt. Monetary regimes are now evolving again, as the new Member States approach euro adoption at varying speeds. Where national currencies are retained for some years, it will be particularly important to slow the build-up of euro-denominated borrowing – which, over an extended period, could expose economies to balance sheet risks in the event of depreciation. Monetary and supervisory policies can contribute to this, as can fiscal policy by helping to avoid excessively high domestic currency interest rates. On the other hand, where the EU-10 progressively give up the freedom to use interest rates for domestic purposes, there could be greater risks of strong credit cycles – and thus of stresses for fiscal policy during periods when adjustment through relative prices may take place slowly.

An implication of regimes, such as ERM II, that involve exchange rate targeting is that fiscal performance and internal policy co-ordination are highlighted in terms of market credibility. The possibility of contagion in financial markets means, moreover, that instability affecting one economy could spread to another. The run-up to the euro also places special demands on policy mix – the relative burden borne by fiscal and monetary policy – to ensure that the euro conversion rate, and the market approach path, correctly reflect fundamentals. For example, a combination of tight money and an easy fiscal stance during the approach to the euro could cause both volatility and an overly appreciated entry rate.

In sum, fiscal policy needs to support growth through expenditure and tax reforms, while also containing deficits and debt as an insurance against risks to stability. High potential growth rates and, in some cases, low public debt are elements that suggest some deficit leeway as policy-makers in the recently acceded Member States seek to protect growth-supportive fiscal programmes. But several factors also underscore the need for prudence in formulating fiscal goals: the scope for somewhat greater volatility in the public finances; the risks of overestimating potential growth and revenue buoyancy during credit and asset price booms; and policy mix and credibility challenges during the run-up to euro adoption. Also, where medium-term goals can be eased, it will be important to avoid a stimulus at times of concern about domestic and external imbalances. As policy-makers take these factors into account, actions to strengthen fiscal institutions hold important scope to improve possible trade-offs, thus helping to ensure that convergence toward higher living standards is both strong and sustainable.

1. Introduction

The Member States that joined the European Union in May 2004 have income levels below the average of the former EU-15. A majority of those in the Baltic region and central Europe face a particularly steep convergence path, and they also have financial sectors that are still developing strongly. The challenge they face, from very differing starting positions, is to ensure that macroeconomic and structural policies are well-designed and well-coordinated, so as to foster strong and sustainable convergence.

Fiscal policy can contribute to this in two ways. First, tax and expenditure policies can help create conditions for strong growth in the private sector – for example, adequate infrastructure and education; a level and structure of taxation that ensures incentives for investment and employment; fiscal support, where required, for economic restructuring; and social safety nets that help cushion distributional hardships caused by economic change and re-orient those affected toward new jobs. Second, fiscal policy can help preserve macroeconomic stability – by offsetting fluctuations in private sector activity, achieving a balanced policy mix, and credibly assuring sustainability of the public debt.

These priorities for fiscal policy are, over the long run, strongly complementary. Sustained expansion in the private sector makes a major contribution to public debt sustainability, and vice versa. Tax and expenditure reforms can both reduce public imbalances and, through a range of channels, improve incentives for the private sector. Nonetheless, tensions can arise in the shorter term between containing deficits and implementing programs to foster growth. This may be especially so where there is a marked scarcity of public goods, or where restructuring entails sizable fiscal costs – both of which apply in a majority of the recently acceded Member States.

The possibility of trade-offs between growth and stability in the EU-10 has been discussed in recent academic and policy literature on the design of fiscal policy – with varying conclusions regarding medium-

term goals and the pace of consolidation. For example, the Sapir Report¹⁴⁴ saw potential to support growth by accommodating wider fiscal deficits in the EU-10 (by comparison with SGP norms). On the other hand, an IMF report on the central European new Member States¹⁴⁵ cautioned that the potential for rapid domestic credit growth as part of the convergence process, as well as the risk of exchange market turbulence, should prompt a very cautious fiscal stance.

In this context, it is important to recall that the EU-10 present a highly varied group in the profile of their public finances. There are wide differences in taxation and expenditure levels, deficit and debt trajectories, progress with convergence, and the influence of monetary and exchange regimes. Any analysis must take full account of such differences – of course without losing sight of a common environment that includes the *acquis communautaire*, the priority of sustained convergence priorities and – at some point in the future – the challenge and opportunity of euro adoption.

To shed light on such issues, this chapter provides a brief review of fiscal trends over the past decade, and considers policy complementarities and trade-offs in the period ahead. It focuses in particular on the scope to enhance potential growth through tax and expenditure reforms and strengthening fiscal institutions; and the stabilizing role of fiscal policy – including the implications of private sector imbalances and of possible volatility in the real and financial economy (which is explored in terms of the components of a debt dynamics equation).

Against this background it suggests, in conclusion, some possible priorities for medium-term fiscal frameworks and comments on complementarities and trade-offs that deserve further study in light of country-specific circumstances.

¹⁴⁴ See A. Sapir et al. (2004)

¹⁴⁵ See IMF (2004c)

2. Macroeconomic and financial background

2.1 Key macroeconomic developments

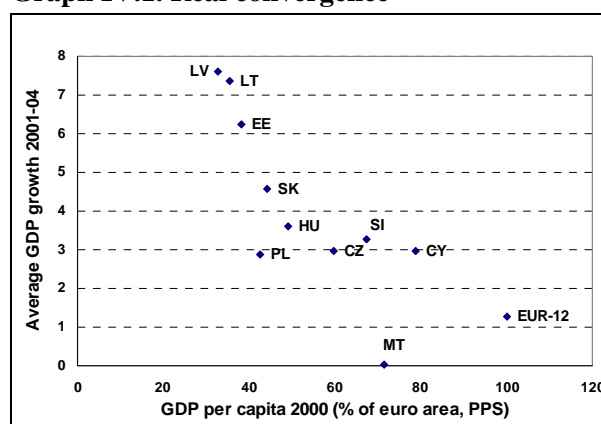
The recently acceded Member States have made remarkable progress in aligning their institutional and economic features with those of longer-standing members of the EU. This has been particularly marked in the former centrally planned economies, where great strides have been made in macroeconomic stabilisation and real and nominal convergence since the beginning of transition. Nevertheless, in spite of these advances, these economies still show significant differences from the EU-15, of which low per-capita income and a less developed financial sector are of particular relevance.¹⁴⁶

Growth performance in the Baltic and central European new Member States (except for the Czech Republic) was consistently better than in the euro area during 1997-2004 (Table IV.1). The three Baltic countries, with lower per capita incomes, achieved notably high growth rates. However, GDP per capita levels in the EU-10 are still considerably below the euro area level – on average half that level. Apart from the Baltics, the lowest level occurs in Poland, while the highest are in Cyprus, Slovenia, and Malta, bringing them close to some euro-area members. The relationship between growth and scope for catch-up is illustrated in Graph IV.1.

Over the last decade, inflation in the EU-10 has fallen substantially – in all cases to single-digit levels (Table IV.1 and Graph IV.2). This reflected a clear orientation of monetary and exchange rate policies. Recent fluctuations were mostly explained by cyclical and other short-term influences, in particular the exchange rate, food and commodity prices, and tax and administered price adjustments. Although the cross-country dispersion of inflation has also fallen, there are still substantial divergences. In 2004, HICP inflation figures ranged from some 1% in Lithuania to 7.4% in Slovakia,

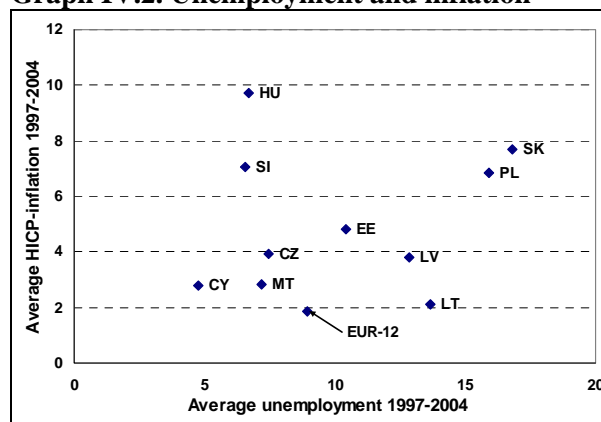
with the latter being a prime example of adjustments in administered prices and indirect taxes. The containment of inflationary pressures will remain a challenge as Balassa-Samuelson effects work their way through the system, wage pressures remain strong, and indirect taxes are further adjusted in line with EU legislation.

Graph IV.1. Real convergence



Source: Ameco.

Graph IV.2. Unemployment and inflation



Source: Ameco.

¹⁴⁶ For a recent review of macroeconomic and structural developments in the EU-10, see European Commission (2004b).

Table IV.1. Selected macroeconomic indicators

| Countries | GDP Per Capita | GDP Growth | | Unemployment | | HICP Inflation | GDP Deflator | | St. deviation | Interest Rates | |
|--|-----------------------|-----------------------|-------------------------|----------------------------|------|-------------------|--------------|------|---------------|---------------------|------|
| | (% of euro area, PPS) | in % (annual average) | St. deviation of growth | (of civilian labour force) | | (annual % change) | (% change) | | of % change | (long-term nominal) | |
| | 2003 | '97-'04 | '97-'04 | 1997 | 2004 | 2004 | 1997 | 2004 | '97-'04 | 2001 | 2004 |
| CZ | 64.3 | 1.8 | 2.0 | 4.7 | 8.3 | 2.6 | 8.3 | 3.7 | 3.4 | 6.3 | 4.8 |
| EE | 45.6 | 6.1 | 3.0 | 9.6 | 9.2 | 3.0 | 10.5 | 3.3 | 2.6 | 10.2 | 4.4 |
| CY | 76.0 | 3.6 | 1.3 | 4.9 | 5.0 | 1.9 | 2.8 | 2.2 | 1.0 | 7.6 | 5.8 |
| LV | 38.3 | 6.7 | 1.8 | 15.2 | 9.8 | 6.2 | 7.0 | 7.3 | 1.5 | 7.6 | 4.9 |
| LT | 42.8 | 5.7 | 3.4 | 12.5 | 10.8 | 1.1 | 14.0 | 3.3 | 5.0 | 8.2 | 4.5 |
| HU | 56.6 | 4.1 | 0.7 | 9.0 | 5.9 | 6.8 | 18.5 | 4.7 | 3.8 | 8.0 | 8.2 |
| MT | 68.3 | 2.4 | 2.9 | 6.3 | 7.3 | 2.7 | 2.3 | 1.7 | 1.6 | 6.2 | 4.7 |
| PL | 43.0 | 3.9 | 1.9 | 10.9 | 18.8 | 3.6 | 13.9 | 2.9 | 4.8 | 10.7 | 6.9 |
| SI | 71.8 | 3.8 | 1.0 | 6.9 | 6.0 | 3.6 | 8.8 | 3.0 | 1.9 | n/a | 4.7 |
| SK | 48.9 | 3.8 | 1.3 | 12.3 | 18.0 | 7.4 | 6.7 | 4.6 | 1.5 | 8.0 | 5.0 |
| EU-10⁽²⁾ | 55.6 | 4.2 | 1.9 | 9.2 | 9.9 | 3.9 | 9.3 | 3.7 | 2.7 | 8.1 ⁽¹⁾ | 5.4 |
| Baltic EU-10⁽²⁾ | 42.2 | 6.2 | 2.7 | 12.4 | 9.9 | 3.5 | 10.5 | 4.6 | 3.0 | 8.6 | 4.6 |
| Centr. Eur. EU-10⁽²⁾ | 56.9 | 3.5 | 1.4 | 8.8 | 11.4 | 4.8 | 11.2 | 3.8 | 3.1 | 8.2 ⁽¹⁾ | 5.9 |
| Island EU-10⁽²⁾ | 72.2 | 3.0 | 2.1 | 5.6 | 6.2 | 2.3 | 2.5 | 2.0 | 1.3 | 6.9 | 5.2 |
| euro area⁽²⁾ | 100.0 | 3.2 | 1.5 | 9.1 | 7.5 | 2.2 | 2.5 | 2.3 | 0.9 | 5.0 | 4.1 |
| St. deviation across EU-10 | 13.7 | 1.6 | - | 3.5 | 4.8 | 2.1 | 5.1 | 1.6 | - | 1.5 | 1.2 |

Source: Ameco, ECB Annual Public Finance Report 2004 (unpublished).

(1) Excluding Slovenia; (2) Unweighted average.

Unemployment remains a major policy challenge in many new Member States and in particular in Poland and Slovakia (Graph IV.2), including due to labour shedding during on-going restructuring, which often is not matched by absorption capacity and flexibility in the labour market.

Interest rates have fallen substantially over recent years, and have become less dispersed. This reflects favourable inflation expectations, declining risk premia, and convergence plays with a view to euro-adoption. However, Hungary in particular stands out as a case where this tendency has recently been reversed.

The new Member States are very open economies. The GDP-share of exports and imports far exceeds 100% in most, with the exception of Poland. Their openness has to some extent influenced past and present choices of exchange rate regimes. The current gamut of regimes ranges from a freely floating currency in Poland to currency boards with the euro in Estonia and Lithuania. The Baltic states, Cyprus, Malta and Slovenia have already become members of ERM II.

Current account deficits have, in general, been significant in most countries over recent years, as is typical for converging economies. The Baltic countries, in particular, have experienced large current account deficits. As the latter have also had relatively small general government deficits or, in the case of Estonia, a surplus, private sector net saving has been particularly negative – in the case of Estonia and Latvia notably also in 2004. In contrast, the picture was rather mixed in the Central European new Member States: while the Czech Republic, Hungary and Slovakia featured negative private net saving in 2004, private sector net saving was positive in Poland and Slovenia. So far, relatively high

current account deficits have been financed to a considerable extent by foreign direct investment. However, as privatisation-related FDI has fallen to a trickle in some countries, and is declining in others, current account financing may now rely more on short-term capital inflows, thus increasing inherent volatility.

2.2 Macroeconomic volatility: recent experience

The EU-10 have in general enjoyed considerably stronger growth than the euro area since the mid-nineties, but rapid growth typically went together with greater macroeconomic volatility (see Graphs IV.4 and IV.5). Part of this may be due to the greater degree of openness of the EU-10, but in addition they faced significant adjustment costs in their transition from central planning to a market economy. Unproductive industries had to be closed; bad debts had to be assumed by the state; and social support had to be provided for a growing number of unemployed. In the early nineties, this led to a considerable output loss and pressure on public finances. For example, GDP contracted in 1992 by more than 30 % in Latvia.

With the perspective of EU accession, the economic situation turned for the better. Strong growth rates were realised, but remained vulnerable to shocks: large swings in GDP growth were still observed. Several recently acceded Member States experienced setbacks in the late nineties due to failed adjustment programmes, while some proved particularly vulnerable to the Russian crisis in 1998.

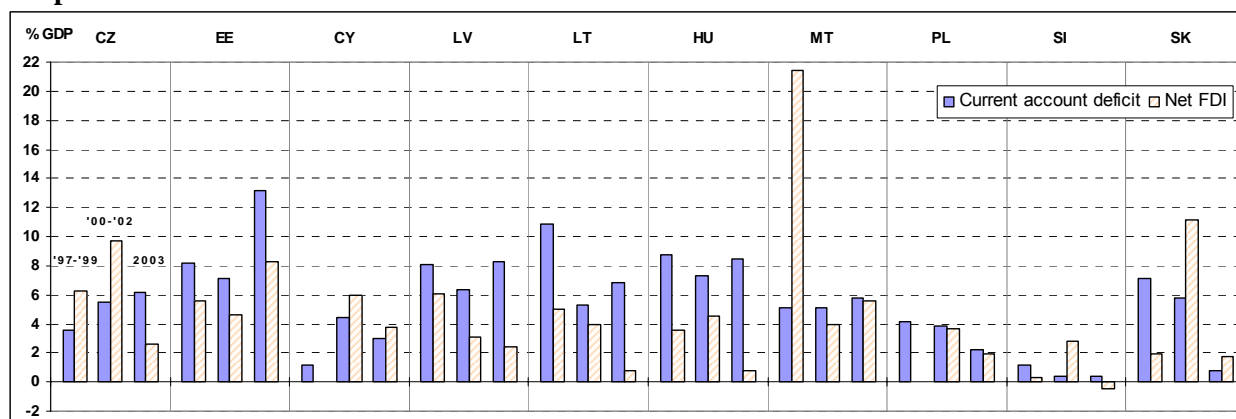
Table IV.2. Selected external indicators

| Countries | Exchange Rate (domestic currency per euro, % change) | | | Exchange Rate Regime | Openness ⁽²⁾ (Exports+Imports, % GDP) | Current Account Balance (% GDP) | |
|--------------------------------|---|-------|---------------------|--------------------------|---|------------------------------------|-------|
| | 1997-2003 | 2004 | 2005 ⁽¹⁾ | | | 1997 | 2004 |
| | | | | | | 2004 | |
| CZ | -3.4 | -6.4 | -1.3 | Managed float | 143.0 | -6.3 | -5.2 |
| EE | 0.3 | 0.0 | 0.0 | ERM II, since 28/06/2004 | 169.3 | -11.4 | -13.5 |
| CY | -0.2 | -1.3 | 0.8 | ERM II, since 2/05/2005 | 97.0 | -4.8 | -5.6 |
| LV | -3.7 | 2.9 | -0.1 | ERM II, since 2/05/2005 | 103.7 | -5.6 | -12.7 |
| LT | -29.0 | 0.0 | 0.0 | ERM II, since 28/06/2004 | 112.1 | -10.0 | -8.4 |
| HU | 31.1 | -7.0 | 0.7 | euro peg, 15% band | 133.6 | -4.4 | -9.1 |
| MT | -3.8 | 0.6 | -0.9 | ERM II, since 2/05/2005 | 158.1 | -5.9 | -2.7 |
| PL | 30.9 | -12.3 | 0.1 | Float | 80.0 | -3.5 | -1.9 |
| SI | 33.7 | 1.0 | 0.0 | ERM II, since 28/06/2004 | 120.4 | 0.3 | -0.7 |
| SK | 4.9 | -4.6 | 0.0 | Managed float | 156.3 | -8.7 | -3.5 |
| Euro area⁽³⁾ | 0.0 | 0.0 | 0.0 | - | 71.3 | 1.6 | 0.8 |

Source: Ameco database.

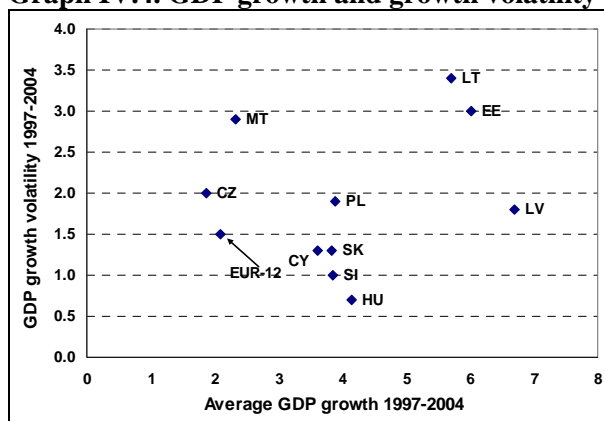
(1) January to March 2004; (2) Goods and services; (3) Weighted average..

Graph IV.3. External current account and FDI



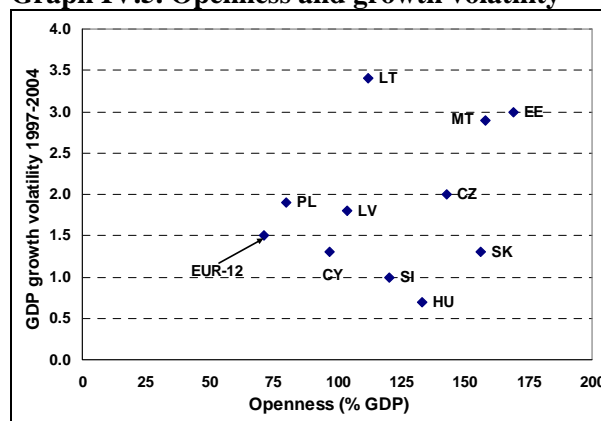
Source: Ameco and Eurostat database.

Graph IV.4. GDP growth and growth volatility



Source: Ameco database.

Graph IV.5. Openness and growth volatility



Source: Ameco database.

Volatility in the past is not necessarily a good guide for the future, particularly if special events occurred. In the present analysis, when assessing volatility, the early nineties are excluded from the reference period, since that was the time when transition shocks were largest. The reference period used starts in 1997, when the ‘Agenda 2000 for a stronger and wider Union’ was published (European Commission (1997)), offering a concrete perspective of accession, though without yet specifying a date.

The standard deviation of growth rates in the EU-10 can be compared with that in euro area countries calculated over the same reference period, 1997-2004, during most of which the euro existed (Table IV.1). The focus here is on two main macroeconomic drivers of fiscal developments: growth and inflation. Greater volatility is observed in the EU-10, which could weigh on the stability of the public finances. In particular, a high volatility in inflation (as measured by the GDP deflator) is noted.

Of course, the euro may have had a stabilising impact on the area economy, and it could be argued that the EU-10 should be compared with a period prior to the euro. To allow for that, comparison can be made also with volatility in euro area economies in 1994-1999, mostly ahead of euro adoption and in that respect more similar to the period that the EU-10 are presently experiencing. This would begin after the exchange rate turmoil of 1992-93 and the associated recession and high fiscal deficits. From 1994, it became gradually clear that the euro would be introduced, a similar situation to that today in most of the EU-10. Using this reference period, the findings above are confirmed. (In the euro area countries, the unweighted standard deviation of growth was 1.1, and that of the GDP deflator was 1.2.) In general, macroeconomic volatility in the EU-10 emerges as higher, even if one excludes the early nineties, when transition shocks were strongest.

At the country level there are differences. The Baltic States (Estonia, Latvia and Lithuania) experienced particularly large swings in output. All of the Baltic and central European new Member States except Slovenia saw marked fluctuations in inflation. Cyprus and Malta were characterised by a high level of nominal stability as illustrated by fairly low volatility in inflation, but output variation was high in Malta.

2.3 Main financial sector characteristics

The level of domestic financial intermediation in the Baltic and central European new Member States is characterized by a still large gap with the euro area. Financial intermediation in these countries occurs mostly through the banking system. However, the size of the banking sectors is small, relative to GDP, compared with the euro area. This is evidenced by the low GDP ratios of broad money and domestic bank claims on the private sector, although the latter are now

growing very rapidly in most countries. Cyprus and Malta, by contrast, have a banking sector broadly comparable to the EU-15.

Table IV.3. Financial intermediation

| Countries | M2 2004 (% GDP) | Domestic bank claims to private sector 2003 (% of GDP) | Domestic bank claims to private sector (% change Dec.03/Dec.02) |
|--------------------------|-----------------------|--|---|
| CZ | 70.0 | 30.7 | 8.6 |
| EE | 42.2 | 33.1 | 32.6 |
| CY | 125.3 | 119.4 | 5.1 |
| LV | 39.8 | 34.6 | 45.3 |
| LT | 32.8 | 20.4 | 58.9 |
| HU | 48.1 | 43.0 | 33.3 |
| MT | n/a | 114.7 | 2.3 |
| PL | 42.1 | 29.0 | 6.7 |
| SI | 54.1 | 41.5 | 15.4 |
| SK | 59.7 | 31.6 | 13.9 |
| EU-10 ⁽¹⁾ | 57.1 ⁽²⁾ | 49.8 | 22.2 |
| Euro area ⁽³⁾ | 94.2 | 112.1 | 5.5 |

Source: IMF IFS, national sources.

(1) Unweighted average; (2) Excluding Malta; (3) Weighted average.

The financial systems of the EU-10 that were formerly centrally-planned economies have only been built up over the past 15 years. They have high degrees of inter-linkage with the euro area, notably with regard to the ownership of intermediaries and use of the euro as a loan and deposit currency. Indeed, while strategies have varied, almost all of the new Member States have encouraged the involvement of foreign investors in the restructuring of their banking sector.¹⁴⁷ Attracted by high margins and growth prospects in the EU-10, foreign investment has helped re-capitalise banking systems, while transferring important expertise and technology. Banking systems are largely well capitalised and profitable, even if the share of non-performing loans remains higher than in other EU countries. The insurance, pension and mutual funds industries are still very small, but fast growing. Facing constraints from under-developed domestic markets, they have invested substantially in foreign assets in several recently acceded Member States.

Although all EU-10 have established domestic markets for money, bonds and equities, these are small in absolute terms and relative to GDP, with a generally limited number of issuers and secondary market activity. Indeed, both fixed income and equity markets are still small and illiquid. In terms of securities outstanding, the EU-10 account for 2 percent of the EU-25 fixed income markets, with only the three biggest markets – i.e. Poland, the Czech Republic and Hungary – larger than the Irish market, which is currently the smallest in the euro area. A common feature of fixed-income markets is the dominance of central government issuance, which accounts between 80 percent and 100 percent in most cases. Issuance by the private sector represents a

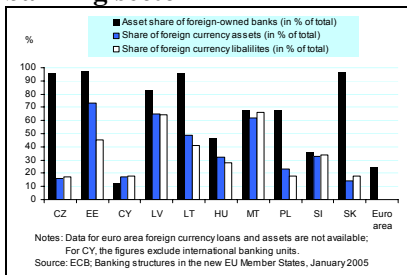
¹⁴⁷ Public banks have retained a significant share of the market only in Poland and Slovenia.

significant share only in the Czech Republic, Slovenia and Estonia.

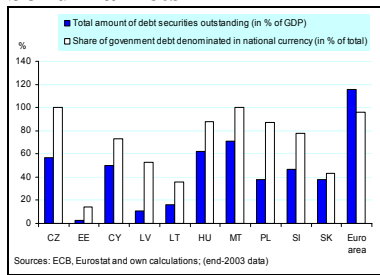
Equity markets in the EU-10 are not yet a major source for corporate financing. Market capitalisation in terms of GDP is less than half that in the euro area for most of the EU-10 and turnover is generally less than one sixth. Levels of development vary widely, however, in part reflecting the choice of privatization method between voucher and other schemes. Poland, the Czech Republic and Hungary have the largest markets in absolute terms,

while Estonia has the largest markets in terms of GDP. To acquire access to a wider investor base, and cheaper capital, a significant number of companies in the new Member States have been cross-listing abroad, mostly in New York and London and to a much lesser extent within the euro area. Several exchanges in the EU-10 have entered strategic partnerships with other exchanges.

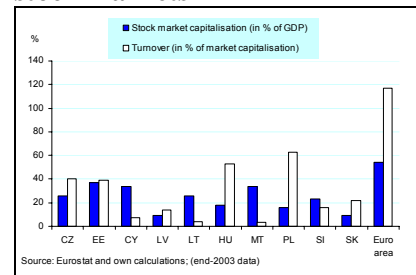
Graph IV.6. Basic characteristics of the EU-10 banking sector



Graph IV.7. Basic characteristics of the EU-10 bond markets



Graph IV.8. Basic characteristics of the EU-10 stock markets



3. Recent developments in the public finances

3.1 Fiscal deficits and public debt

Experience in managing the public finances has varied widely across the recently acceded Member States. For the former centrally-planned economies, budget balances were strongly affected by transition-related effects, including bank restructuring operations – even to some extent after 1997.¹⁴⁸ Apart from a few exceptions, general government deficits have not shown a clear tendency to decline.

In 2004, Estonia was exceptional in registering a budget surplus, while the other Baltic states had deficits well below 3% of GDP – a performance that in part reflects the context of hard peg exchange regimes. Apart from Slovenia and the Czech Republic, the deficit of the other countries exceeded 3% of GDP by varying margins. Slovakia came closest to this level, while Poland had the highest deficit among the central European new Member States. The deficits of Cyprus and Malta were around 4% and 5% of GDP, respectively. The deficit-to-tax revenue ratio in the central European countries (except Slovenia), the islands and in Lithuania was significantly higher than in the euro area, suggesting that it would be more difficult to eliminate the deficit or part of it through revenue measures.

Public debt ratios in 2004 were below the 60% of GDP Treaty reference value in all the new Member States except Cyprus and Malta. Estonia had a very low debt (some 5%), whereas Hungary was close to 60%. Taking tax revenues as a reference point, the picture relative to the euro area typically is less favourable. The interest burden as a ratio of tax revenues is also higher than in the euro area in Hungary, Cyprus and Malta, and close to the euro area in Poland and Slovakia. Debt maturities show a fairly high short-term share in the Czech Republic and Hungary. Foreign-currency denominated debt is particularly high in the Baltic states, reflecting

their currency arrangements and advanced progress toward euro adoption, as well as in Slovenia and Hungary.

Experience across the EU-10, finally, illustrates the influence of monetary and exchange rate regimes on deficits and debt levels. In the Baltic states the introduction of hard pegs was underpinned by medium-term goals of budget balance and low levels of public debt. In most central European Member States, by contrast, more flexible exchange arrangements are associated with higher deficits and debt.

3.2 Composition of public revenues and expenditures

About half of the EU-10 have reduced their revenue-to-GDP ratios since 1997 (or the earliest year thereafter for which data are available). A caveat applies here, since data suffer frequently from inadequate consolidation practices, in particular in the earlier years. As regards direct and indirect taxes and social contributions, again about half of the countries have reduced the ratio. In the Baltic and central European countries, the largest combined reductions are observed in Slovakia and Poland – and reflect also an increase in the relative share of indirect taxes. All the Baltic countries have reduced taxation as well. No reductions took place in the Czech Republic, Hungary and Slovenia. As for social contributions, any reductions were relatively marginal.

On the expenditure side, apart from the Baltics, only two countries apparently reduced primary expenditure-to-GDP ratios in the period from 1997 (or the earliest year, for which data are available thereafter) to 2004 – with some earlier reductions being reversed in the latter year. Again, however, the caveat of potentially inadequate consolidation applies. Examining individual expenditure components reveals that only four countries managed to reduce general government consumption, most notably Estonia and Lithuania.

¹⁴⁸ For a discussion of fiscal trends and issues in the late 1990s, see European Commission (2002a).

Table IV.4. Selected fiscal indicators

| Countries | General Government Net Borrowing | | | | General Government Gross Debt | | | | General Government Interest Payments | | | |
|--------------------------------|----------------------------------|------|----------------------------------|------|-------------------------------|------|----------------------------------|-------|--------------------------------------|------|----------------------------------|------|
| | % of GDP | | % of tax revenues ⁽¹⁾ | | % of GDP | | % of tax revenues ⁽¹⁾ | | % of GDP | | % of tax revenues ⁽¹⁾ | |
| | 1997 | 2004 | 1997 | 2004 | 1997 | 2004 | 1997 | 2004 | 1997 | 2004 | 1997 | 2004 |
| CZ | 2.4 | 3.0 | 6.9 | 8.4 | 12.7 | 37.4 | 35.6 | 103.6 | 1.2 | 1.3 | 3.4 | 3.5 |
| EE | -1.7 | -1.8 | -4.8 | -5.5 | 6.3 | 4.9 | 17.5 | 15.1 | 0.4 | 0.2 | 1.2 | 0.7 |
| CY | n/a | 4.2 | n/a | 12.6 | n/a | 71.9 | n/a | 213.8 | n/a | 3.4 | n/a | 10.0 |
| LV | -1.5 | 0.8 | -4.5 | 2.6 | 11.1 | 14.4 | 33.9 | 50.7 | 1.0 | 0.8 | 3.1 | 2.7 |
| LT | 1.2 | 2.5 | 3.9 | 9.0 | 15.8 | 19.7 | 53.0 | 71.8 | 0.8 | 1.0 | 2.8 | 3.7 |
| HU | n/a | 4.5 | n/a | 11.3 | 63.9 | 57.6 | 166.6 | 145.4 | n/a | 4.3 | n/a | 10.8 |
| MT | n/a | 5.2 | n/a | 14.6 | 48.1 | 75.0 | n/a | 211.4 | n/a | 4.1 | n/a | 11.4 |
| PL | 4.5 | 4.9 | 11.7 | 14.0 | n/a | 43.6 | n/a | 123.7 | 4.4 | 2.6 | 11.3 | 7.8 |
| SI | n/a | 1.9 | n/a | 4.7 | n/a | 29.4 | n/a | 73.8 | n/a | 1.9 | n/a | 4.7 |
| SK | 6.2 | 3.3 | 16.2 | 11.1 | 33.0 | 43.6 | 86.7 | 145.7 | 2.2 | 2.2 | 5.8 | 7.4 |
| Euro area⁽²⁾ | 2.7 | 2.8 | 6.4 | 6.7 | 75.1 | 71.3 | 176.6 | 173.0 | 5.1 | 3.3 | 12.2 | 8.1 |

(1) Including social contributions; (2) Weighted average.

Source: Ameco database.

Table IV.5. Government debt composition (2003)

| Countries | Gross consolidated debt (% GDP) | Of which Initial maturity up to one year (% of GDP) | Of which foreign-currency denominated (% of GDP) |
|--------------------------------|---------------------------------|---|--|
| CZ | 37.6 | 10.9 ⁽¹⁾ | 1.1 |
| EE | 5.3 | 0.3 | 2.9 |
| CY | 72.2 | 1.9 ⁽²⁾ | 13.8 ⁽²⁾ |
| LV | 15.3 | 0.8 ⁽²⁾ | 9.4 ⁽²⁾ |
| LT | 21.5 | 1.1 | 13.9 |
| HU | 59.0 | 11.7 | 14.4 |
| MT | 72.0 | n/a | n/a |
| PL | 45.4 | n/a | n/a |
| SI | 27.0 | 2.0 | 13.5 |
| SK | 42.8 | 5.8 | 6.7 |
| Euro area⁽³⁾ | 70.6 | 9.2 | 1.0 |

(1) Figure refers to 2001; (2) Figure refers to 2002;

(3) Weighted average.

Source: Commission services.

Reductions in cash social benefits basically occurred only in Latvia and Slovakia, and subsidies have been cut sizably only in Poland and Slovakia. Slovakia also reduced considerably gross fixed capital formation, though from a very high level in 1997.

Taking 2003 as a reference year, two points are striking as regards the overall expenditure share. First, in spite of significantly lower per-capita income, the GDP-shares of total and primary expenditure are in many cases in the same range or above the euro area average. This is out of line with traditional theoretical considerations (e.g. Wagner's law), which imply a positive correlation between income level and government size. Second, the shares of key expenditure components vary considerably among the new Member States, even those with similar per-capita income, although the Baltic states are closely

clustered. Indeed, the GDP-shares of key expenditure components among the EU-10 (even those with similar income levels) vary by factors between roughly 1½ and 6. The highest variation occurs in subsidies (around 3% of GDP in the Czech Republic and ½% of GDP in Poland) and in gross fixed capital formation (around 5½% of GDP in Malta and 1½% of GDP in Latvia).

More specifically, the GDP-shares of total and primary expenditure of the central European new Member States (except Slovakia) and the two islands are in the same range or above the euro-area level. By contrast, the Baltic states and Slovakia cluster around a considerably lower GDP-share. Broadly similar results hold for total government consumption, although here Latvia and Slovakia join the group in the range of the euro-area, while Poland (with low social transfers in kind) forms a cluster with Estonia and Lithuania. The GDP share of public employees' compensation is typically high. Subsidies are higher in all central European new Member States except Poland.

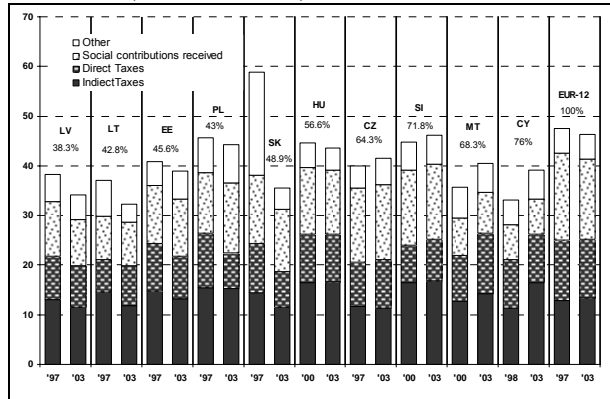
The GDP-share of gross fixed capital formation is similar to, or exceeds, that in the euro area, except in Latvia. This could indeed be expected in catching-up economies, but across the EU-10 there does not seem to be a close correlation between GDP per capita and the share of capital formation, which varies widely.

3.3 Volatility in the public finances: recent experience

In some respects, the public finance situation in the EU-10 compares favourably with that in the euro area. Public debt ratios are in many cases lower; and strong nominal growth contributes to virtuous debt dynamics. Moreover, fiscal balances may be somewhat less sensitive to the economic cycle. On the other hand, the economies of the new Member States have been subject

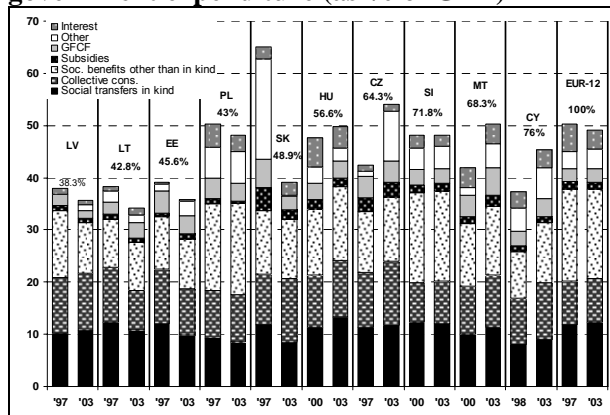
to somewhat greater macroeconomic and fiscal volatility. Experience in recent years provides a number of indications in these respects, which are a useful context for considering medium-term fiscal goals.

Graph IV.9. Composition of general government revenues (as % of GDP)



Countries are ordered, within the main geographic regions, by income per capita (PPS) as % of the Euro-area (EUR-12) in 2003, which is indicated below the country identifier.

Graph IV.10. Composition of general government expenditure (as % of GDP)



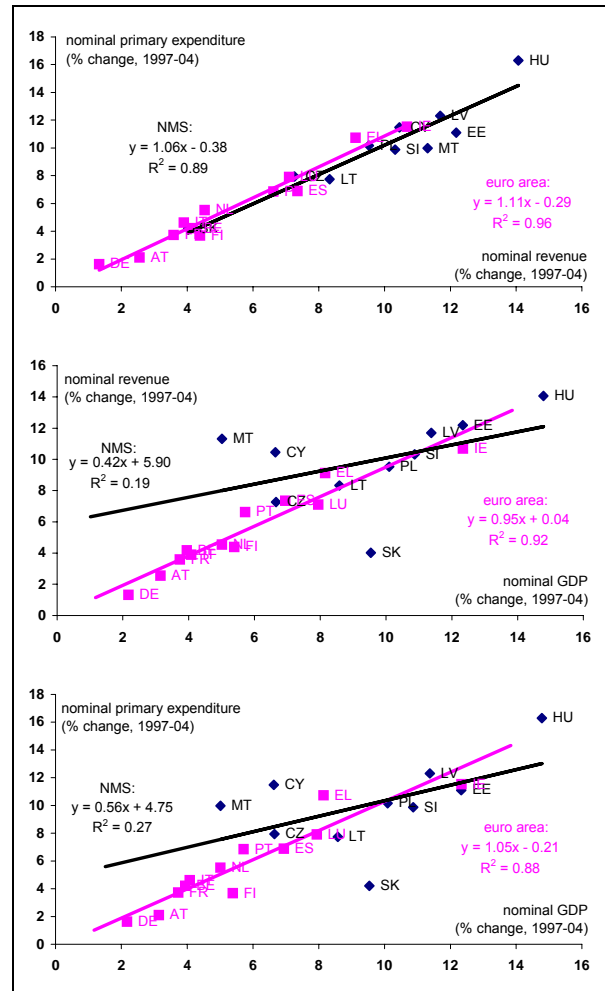
Countries are ordered, within the main geographic regions, by income per capita (PPS) as % of the Euro-area (EUR-12) in 2003, which is indicated below the country identifier.

Regarding fiscal performance and nominal growth, there appears to be less of a link between these developments than in euro area members. This may reflect a lower size of the public sector in the EU-10, the impact of structural reforms, and the broad economic transformation that is still underway in the EU-10.

The importance of nominal growth for revenue and expenditure dynamics in the euro area and the recently acceded Member States is different. The relationship in the euro area is much stronger than in the recently acceded Member States, as reflected in the steeper cross-country regression slope between changes in nominal revenues and nominal GDP (Graph IV.11, mid- and lower panel).¹⁴⁹ This is in part explained by the

higher weight that the government represents in the euro area compared, on average, to the EU-10. Revenue takes a share of 46 % of GDP (unweighted, 1997-04) in the euro area compared to 41 % of GDP in the EU-10, while for total expenditures the numbers are 47 % of GDP versus 44.5 % of GDP. Furthermore the transition process in the EU-10 led to structural change in the economy and in public finances weakening the relation between GDP growth and government revenue or expenditure. Statistical revisions of the classification of certain expenditure and revenue categories and the consolidation of the different levels of government may add to the weaker relation between nominal developments and public finances in the new Member States.

Graph IV.11. Expenditure and revenue dynamics in the new Member States and the euro area



Source: Commission services.

As in the euro area, a strong relation between government revenue and expenditure is observable across EU-10. Both across euro area countries and new

¹⁴⁹ However, there are important country differences. In Cyprus and Malta expenditure and revenue grew more

strongly than GDP, while in Slovakia fiscal consolidation led to a reduction of the weight of the government in the economy (Graph IV.11, mid and bottom panel).

Member States, primary expenditure growth was on average faster than total revenue growth in the period examined (Graph IV.11, top panel), and contributed to deficits. In the EU-10, Hungary stands out as a country where primary expenditure growth was particularly rapid compared to revenue growth, while in Estonia the opposite is noted.

Although the link between nominal growth and revenues and expenditures appears weaker in EU-10, there is evidence that the public finances in the EU-10 are less stable than the euro area. This can be gauged by directly looking at the standard deviation of fiscal aggregates over past years. Both the share of general government revenues and primary expenditures in GDP have been much more volatile over the 1997-2004 period compared with the euro area. The Baltic States in particular experienced large swings and variability in government expenditure and revenue, but its impact on volatility of debt and primary deficit appeared contained. The four larger new Member States (Czech Republic, Hungary, Poland and Slovakia) are

characterised by relatively large variability in primary expenditure which in some cases fuelled instability in the primary deficit. Concerning the two islands (Cyprus and Malta), the public finances appeared subject to shocks to revenues in Malta, and both countries saw some debt volatility.

Interest rates, especially short-term interest rates, have been very volatile in the EU-10. However, this did not lead to a big difference with the euro area in volatility as far as the implicit interest rate on government debt is concerned. Volatility in the debt ratio is of about the same size, but behind this is a rising trend in the EU-10, while the debt ratio declined in the euro area.

In general, however, volatility measured by the annual standard deviation, is wider in the recently acceded Member States compared to the euro area countries. The difference is most striking for nominal expenditure and revenue growth, which is partly explained by higher inflation in the EU-10. The primary balance also displays a higher volatility in the new Member States.

Table IV.6. Volatility in fiscal variables (1997-2004)

| | General government primary deficit (% GDP) | | General government debt (% GDP) | | General government revenues (% GDP) | | General government primary expenditure (% GDP) | | Implicit interest rate on debt (%) | |
|--|--|----------------|---------------------------------|----------------|-------------------------------------|----------------|--|----------------|------------------------------------|----------------|
| | Avg. | Std. deviation | Avg. | Std. deviation | Avg. | Std. deviation | Avg. | Std. deviation | Avg. | Std. deviation |
| CZ | 4.4 | 3.0 | 23.9 | 10.0 | 39.9 | 1.3 | 44.3 | 3.8 | 6.7 | 2.4 |
| EE | -0.8 | 2.0 | 5.3 | 0.6 | 38.9 | 1.3 | 38.1 | 2.1 | 6.5 | 1.3 |
| CY | 0.7 | 1.5 | 64.0 | 5.1 | 36.2 | 2.7 | 36.9 | 3.3 | 5.7 | 0.4 |
| LV | 1.0 | 2.0 | 13.0 | 1.8 | 36.2 | 2.5 | 37.2 | 2.5 | 7.7 | 1.2 |
| LT | 1.2 | 1.3 | 20.7 | 3.0 | 34.8 | 2.3 | 36.0 | 3.2 | 7.2 | 1.0 |
| HU | 1.0 | 2.9 | 57.9 | 3.9 | 44.9 | 2.1 | 45.9 | 3.0 | 9.0 | 1.1 |
| MT | 2.9 | 1.8 | 60.8 | 9.1 | 40.5 | 5.0 | 43.4 | 4.8 | 6.4 | 0.7 |
| PL | 0.7 | 0.8 | 40.6 | 3.5 | 44.3 | 0.9 | 45.0 | 1.4 | 7.4 | 1.1 |
| SI | 0.3 | 0.4 | 27.5 | 2.4 | 45.4 | 0.6 | 45.7 | 0.2 | 9.0 | 1.4 |
| SK | 3.2 | 2.3 | 42.8 | 6.3 | 46.7 | 8.8 | 50.0 | 9.5 | 8.2 | 1.5 |
| EU-10⁽¹⁾ | 1.5 | 1.8 | 35.7 | 4.6 | 40.8 | 2.8 | 42.2 | 3.4 | 7.4 | 1.2 |
| <i>Baltic EU-10⁽¹⁾</i> | 0.5 | 1.8 | 13.0 | 1.8 | 36.6 | 2.0 | 37.1 | 2.6 | 7.1 | 1.2 |
| <i>Centr. Eur. EU-10⁽¹⁾</i> | 1.9 | 1.9 | 38.5 | 5.2 | 44.2 | 2.7 | 46.2 | 3.6 | 8.1 | 1.5 |
| <i>Island EU-10⁽¹⁾</i> | 1.8 | 1.7 | 62.4 | 7.1 | 38.4 | 3.9 | 40.2 | 4.1 | 6.1 | 0.6 |
| Euro area⁽¹⁾ | -2.9 | 1.5 | 66.0 | 4.7 | 46.1 | 1.0 | 43.1 | 1.4 | 5.8 | 0.9 |

(1) Unweighted average.

Source: Ameco, ECB.

4. Financial challenges during convergence

4.1 Introduction

A key question, particularly in the Baltic region and central Europe, is whether the recent economic and financial environment for fiscal policy is a relevant guide to the future. Many sources of economic volatility now lie in the past, and the structure of economies and the public finances have matured greatly during the course of transition over the past decade and a half. However, significant structural transformations are still underway. In both trade and financial terms, these economies are very open; and those in the Baltic region and central Europe also have fairly small and undiversified financial systems. They are thus particularly dependent on financing from international capital markets; and as privatization-related FDI tapers off, the composition of this financing may become more volatile. A number of these economies, moreover, have sizable public sector borrowing requirements, in addition to the financing needs of the private sector.

As regards the setting for fiscal policy three elements of financial market dynamics are potentially important in this regard: a further expansion of debt-creating capital inflows; an associated rapid catch-up in levels of domestic credit to the private sector; and, at varying points in the future, the approach to euro adoption.

To shed light on these challenges, the present section explores aspects of financial convergence and private sector imbalances, and considers the potential fiscal impact of shocks in the real and financial economies. It then brings these elements together in the framework of a standard debt dynamics approach. This places in a single perspective several key elements that will influence public debt developments in the EU-10 over the period ahead – including possible shocks to interest rates and exchange rates, as well as output, emanating from financial markets. Finally, the scope of contingent liabilities is discussed. These elements thus provide an input to the analysis of sustainable medium-term fiscal goals, with an emphasis on potential financial risks.

4.2 Credit booms and private sector imbalances

In the Baltic States and the five central European recently acceded Member States, levels of credit to the private sector are likely to rise sharply over the coming decade from levels that are currently very low, even relative to GDP. This process has the potential to accelerate real sector convergence through investment financing and consumption smoothing. However, experience in other countries illustrates potential hazards in rapid financial sector growth. Capital markets could place economic gains at risk by transmitting external shocks. In addition, financial market imperfections, including swings in risk assessment, could lead to a misallocation of resources or jeopardize the funding of fiscal and external deficits.

Research on credit booms suggests that most systemic stresses result from common exposures across institutions to macroeconomic risk factors, and that this type of financial distress that carries the more significant and longer-lasting real costs (Borio 2003). The trigger for a downturn may be in the financial sphere (e.g. asset price correction) or in the real economy (e.g. unwinding of an investment boom). A key difference in recent models of credit cycles compared with traditional ones is that the boom-bust dynamics are largely endogenous. The boom sows the seeds of the subsequent bust (Borio et al, 2001). In particular, investors' attitude towards risk tends to behave pro-cyclically, supporting the building up of large financial imbalances and then aggravating the correction. Moreover, economies at an intermediate level of financial development may be more unstable than either very developed or underdeveloped economies, in terms of the impact of shocks and of cyclical behaviour (Aghion et al, (2004)). Fully open capital accounts, moreover, can complicate the goals of stabilization.¹⁵⁰ Resilience is likely to

¹⁵⁰ In this latter context, it is important to keep in mind the broader global context of abundant liquidity and low

increase as the structure of financial systems and the composition of asset portfolios become more diversified.

These considerations underscore the need to evaluate possible risks to financial stability when forming a judgement on the optimal fiscal stance. Two financial scenarios for convergence may help illustrate this. In a benign scenario, favourable rates of return to capital in the EU-10 (due to low capital/labour ratios) lead to high investment. Together with consumption-smoothing, this results in external current account deficits that could be sizable but are financed by stable capital inflows. Including a high share of FDI, this import of savings induces beneficial microeconomic effects through improvements in know-how, technology spill-overs, etc. As a setting for this process, the strengthening legal and institutional framework helps create an enabling environment for efficient financial intermediation. Risk premia act as balancing influence that helps keep credit growth, capital accumulation and expanding consumption on a sustainable path. This helps ensure sustainable domestic counterparts to the current account deficit and avoid volatility in financial and economic conditions.

There are, however, financial risks to this scenario. A core concern is that market imperfections (asymmetric information, moral hazard, pro-cyclical behaviour of risk premia) could result in risks to stability. In other words, domestic and foreign creditors' perception of income prospects and economic risks could initially be 'exuberant,' resulting in credit expansion above an equilibrium path, in an environment of strong foreign capital inflows. A pro-cyclical behaviour of risk premia might lead to a misallocation of credit (e.g. a bias towards property and consumption); asset price bubbles; and exposure of non-financial firms to unhedged foreign currency borrowing. At the macroeconomic level, the counterparts of these distortions would be unproductive investment and unduly strong consumption. These could drive the external current account deficit into unsustainable territory, while market financing could become more short-term and volatile. At some point this cycle could go into reverse in a potentially disruptive fashion. This could result in currency and financial market turbulence; and, depending on rigidities in real sector markets and unhedged financial exposures it could lead to deep and protracted losses of output. Since the sources of such volatility would lie in risk premia problems in the private sector, they could emerge even if fiscal policy was observing the reference values of the Treaty.

While the risks of increased interest and exchange rate volatility may be especially relevant before euro adoption, credit booms can occur in any economy,

inflationary pressures: the recent compressed risk premia in global bond and credit risk markets will typically not be sustained over the economic cycle.

including under the euro. Under monetary union, the risk of an exchange market crisis is partially transformed into a risk of unwarranted real appreciation (through relative price movements) that could be hard to reverse, due to the downward stickiness of wages and prices. Damage to growth through this route would also impact the public finances.

4.3 Potential sources of financial risk

In general, progress in macroeconomic stabilisation and the perspective of EU accession supported increasingly stable financial market conditions in the EU-10 over recent years. While the financial systems of the EU-10 are at present generally considered to be sound¹⁵¹, there is nevertheless a set of potential vulnerabilities that can be identified for several of the EU-10, such as increased interest rate volatility, foreign currency exposures, high domestic credit growth rates and contagion risks.

Driven by economic convergence, progressive capital account liberalisation and the medium-term perspective of euro adoption, long term government bond yields in the new Member States have already converged significantly toward euro-area levels. Any emerging stress in the financial system may be reflected first in the development of short term interbank rates. The evolution of domestic 3-months interbank spreads to the euro has varied among the EU-10, with, for example, rather narrow spreads in recent years for Estonia, Lithuania, the Czech Republic, Latvia and wider spreads in Hungary, Poland and – until very recently – Slovakia.

In practice, a reversal in market sentiment – leading to a reduction of capital inflows or even capital outflows – could be triggered by either a specific event in the country itself, or a sudden or sharper-than-expected rise in global interest rates or credit risk premia vis-à-vis emerging markets. Efforts to constrain exchange-rate movements would then trigger interest-rate responses and – if market sentiment failed to recover – a possibly sharp realignment of the exchange rate. As fixed income markets in the EU-10 are generally small and illiquid, they are potentially vulnerable to reversals in capital flows. Moreover, there is a danger that, in illiquid bond markets, prices signal imperfectly and probably with a lag, changes in financial market views.

The impact of interest rate and exchange rate variability on the real economy depends on the extent to which specific sectors are exposed – including through unhedged foreign currency borrowing by corporations and households. The share of net foreign liabilities to GDP is above 60% in Estonia and Latvia, and relatively high in some others. Facilitated by cross-ownership with euro-area Member States, the share of foreign currency

¹⁵¹ See IMF FSAP country reports:

<http://www.imf.org/external/np/fsap/fsap.asp#cp>

lending – mainly in euro – is notable in Estonia, Lithuania and Hungary, while Latvia has a high dollar exposure. Only in the Czech Republic can the share of foreign currency loans in total be described as low. While foreign currency deposits partly counterbalance exposure in the EU-10, it is probable that foreign currency borrowing by some firms and by households is unhedged, creating an exposure to depreciation.

A further common characteristic of the EU-10 has been a rapid credit expansion over the past years. Even though this expansion started from very low levels and is an integral part of the progressing economic catching up process as well as the deepening of financial intermediation, the development of exposures of different sectors and the allocation of capital have to be monitored carefully over the next years. While the convergence process started off mostly with a strong expansion of FDI and government debt, strong credit growth in the private sector is now fuelled by the decline in domestic interest rates, the compression of credit spreads, as well as the economic recovery and associated shift in expected earnings. In many of the EU-10, the credit expansion is at present most dynamic in the household sector, mainly in the form of mortgages, but also consumer loans and credit cards.

Although risks are mitigated by the low starting levels and the expectations of raising income levels, sustained dynamic credit growth might, over time, raise questions about the quality of credit allocation, the indirect vulnerability of the financial system via exposures of borrowers vis-à-vis exchange rate movements as part of the borrowing is foreign currency based and – ultimately – the sustainability of the level of indebtedness in case of an economic downturn. Moreover, there are risks of fuelling asset price bubbles, notably in the housing sector. If credit booms suddenly end, e.g. related to banks abruptly tightening credit conditions or in the event of a sharp and unexpected rise in interest rates, the ensuing potentially significant deterioration of banks' loan portfolio could weaken the financial system, dent real convergence and economic growth.

A final common risk in the EU-10 is the transmission of financial instability via contagion in capital markets – a phenomenon that is not unusual across countries which share similar characteristics. This could be particularly damaging during ERM II participation, as a critical phase of economic and financial convergence in view of fulfilling the Maastricht criteria. Moreover, even though the foreign ownership of the EU-10 banking system is, in principal a main asset for a sustained convergence process, special attention has been drawn to circumstances where the concentration of foreign ownership could become a liability to new Member States with a specifically high exposure. Even though this risk seems currently of theoretical rather than practical relevance, it nevertheless highlights the more general need to improve cross-border and cross-sector

supervision in an increasingly integrated EU financial system.

To set these issues in perspective, it is important to weigh a number of core financial strengths in the EU-10, which differentiate them from the experience of many other economies at this stage of financial development. First, financial supervision has been developing strongly as a result of the observance of international standards and codes and the alignment of domestic frameworks with the *acquis communautaire*. Second, banks are on average well-capitalized; leverage in the household and corporate sectors is typically low; and foreign currency borrowing is at this point still modest relative to GDP – implying that unhedged exposure is smaller still. Third, comprehensive assessments under the IMF-World Bank Financial Stability Assessment Program in the early years of this decade indicated that systems were typically resilient to shocks. To the extent, therefore, the issues discussed in this section raise potential concerns, these relate mainly to the scope for dynamic trends to emerge over time, posing challenges for policy-makers during the course of the convergence process.

In assessing how strong credit growth and wide private sector imbalances may shape the setting for fiscal policy, past experience of converging economies within the EU is a valuable reference point. In some cases the public sector balance played an important compensating role during phases of strong expansion; but there was also experience of an easy fiscal stance during booms resulting in a need for restraint at a later stage, thus precluding flexibility when there was a sharp slowdown in activity.

Experience with private sector dynamics during convergence in Portugal and Spain sheds interesting light on this topic (Box IV.1). In terms of financial market setting, it underscores the importance of policy mix issues as these affect the exchange rate in the run-up to euro adoption; and also the concern that potential growth and revenue buoyancy may be over-estimated in the late stages of a credit and asset price boom.

As regards the contribution of fiscal policy specifically, the experience in Portugal and Spain also highlights important opportunities, risks and limitations. There is the scope – in a context of falling interest rates and the elimination of liquidity constraints under monetary union – to advance with needed budgetary consolidation. There is the risk of an 'exit problem' from a boom in the form of simultaneous retrenchment in both the private and the public sector. Finally, as this experience underscores, there are also limits to what fiscal policy can deliver in any given monetary and real sector setting. Sound fiscal policy, by itself, can only go so far in containing economic imbalances and cushioning shocks to growth or problems with competitiveness over the medium or long term.

Box IV.1. Financial imbalances on the road to EMU: lessons from Portugal and Spain

Since the late nineties, Portugal and Spain have shared a number of economic features associated with accession to EMU, and the related convergence process.⁽¹⁾ Strong anti-inflationary commitment, coupled with structural reforms, underpinned the credibility of policies in a setting of economic expansion. GDP grew in both countries by more than 3.5% annually. Rising income expectations linked to the run-up to the euro, together with supply-side developments in financial markets (including factors such as tax incentives for house purchase), supported a very strong momentum in private consumption and investment, and in particular construction. Although real estate was the main target of the credit boom, consumer credit also grew rapidly, from a low base. A decline in saving, and rising private indebtedness, were evident. In Spain, real estate appreciation was a factor⁽²⁾.

Both economies experienced adverse cost developments in this phase. In Spain, there was a positive inflation differential relative to the euro area, apparently due to higher mark-ups in sheltered sectors, in a context of wage moderation. In Portugal, wage increases in excess of productivity gains occurred in a tight labour market. Unit labour costs, which rose at 1% annually in the euro area, rose by close to 4% annually in Portugal and nearly 2.5% in Spain.

One differentiating aspect lay in exchange rate policies during the run up to the euro. While Spain experienced depreciation until 1995, Portugal supported an appreciated currency. In fact, Portugal was almost the only country in the current euro area whose real effective exchange rate did not depreciate in the second half of the nineties. The result was a worse external competitiveness position in Portugal than in Spain. Consequently, the external balances performed differently in the two countries. In 2000, Portugal registered a peak current account deficit of above 10% of GDP, the highest in the euro area, and the state's net lending worsened to some 9% of GDP from a situation of close to balance in 1995. In Spain, during the 1995-1998 high growth period, a balanced position on the current account was registered, coupled with a net lending position of the nation of 1% of GDP (Graph IV.12).

Against a similar backdrop of strong internal demand, the stance of fiscal policy differed markedly (Graph IV.13). In Spain, balancing the public finances was a key tenet of policy. Adjustment was based on a reduction in the current expenditure (e.g., civil servants salaries were frozen in 1994 and 1997) and a restructuring of revenues, including a full reform of the personal income taxation. Moreover, the government promoted an important privatization policy. Gross debt, and the debt service burden, continued to fall. Spain reached a position of budgetary balance in 2001, which was maintained during the following years. This consolidation effort allowed policy to work as a stabilisation instrument. Despite a fall in private saving, national saving was maintained. Fiscal policy in Portugal, by contrast, amplified the effects of easy monetary and financial conditions over the second half of the nineties. Current primary expenditure was kept on a clearly expansive path until 2001, mainly reflecting higher pay and numbers in the public service, and also non-cash social transfers. Strong revenue growth resulting from lively domestic demand, together with falling interest expenditure, provided sufficient margin to meet the Maastricht requirements. With no fiscal offset to private sector developments, the national savings rate gradually declined.

In Portugal, after a period of strong credit growth, high indebtedness and rising interest rates triggered a sharp re-assessment by private sector agents amid a more gloomy growth outlook. Household consumption decelerated and the savings rate started to increase. Almost simultaneously, corporations started boosting their savings rates as well. The strongest effects were felt in 2003, the year in which Portugal went into a recession, as real GDP fell by 1.1% on account of a shrinking domestic demand. After 2001, Portugal registered improvement in its external imbalance. But the loose fiscal stance pushed Portugal into a situation of excessive deficit in 2001, and in mid-2002 policy was shifted – with a sharp slowdown in current expenditure, mainly reflecting near-freezes of public wages and employment, coupled with one-off revenue measures. Against the background of weak domestic demand and an adverse external outlook, fiscal policy continued to amplify the business cycle, but now in its downturn.

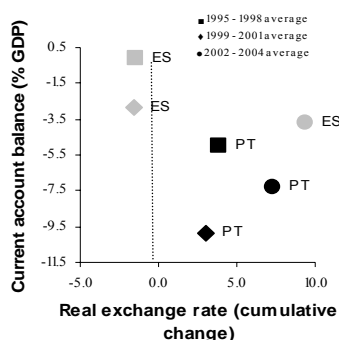
In Spain, since budgetary adjustment had been relatively intense since 1995, there was no need to tighten policy at a time of sluggish growth. Still, private sector imbalances have left some legacy in terms of economic vulnerability. Easy monetary and financial conditions have continued to stimulate household spending. In this sense, the ratio of household debt to disposable income has risen more rapidly throughout the cycle - reflecting the major importance of housing finance, mainly at short-term variable interest rates. The demand for credit has shown strong inertia, with growth rates persistently higher than 15% through 2004, for instance. These factors confer certain elements of risk to the sustainability of financial balances in the household sector. In fact, financial wealth has been shrinking progressively as a result of increasing indebtedness (currently above 100%). As a consequence, the saving capacity of households is neutralized, showing a net borrowing capacity since 2004 (Graph IV.14). Consequently, in Spain, no adjustment in domestic demand has been observed so far. Savings rates of both households and enterprises have continued to decrease throughout the period until the present. Other signs of risk in Spain relate to an intensification of the unbalanced growth pattern noted above. Exports and investment in equipment have been losing dynamism. A gradual deterioration of competitiveness is driven by persistent differentials in unit labor costs. Low relative productivity of market goods has persisted. Since 2000 a weakening of the balance of payments has emerged (Graph IV.12). This led to measures to increase productivity in sectors such as energy, transport, and telecommunications.

From this comparative overview, several elements emerge. Firstly, strong domestic demand – in a context of falling interest rates and the elimination of liquidity constraints under monetary union – presents a favourable scenario to advance budgetary consolidation. Secondly, there are risks of facing multiple imbalances, the simultaneous correction of which may trigger a slump in output as the economy shifts abruptly from overheating to subdued growth. Thirdly, it is important to enhance competitiveness and productivity as lasting routes to growth.

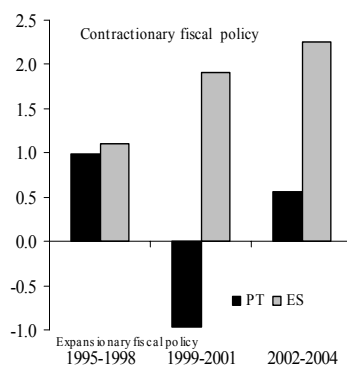
(1) See Banco de España (2003) and European Commission (2004d).

(2) See Malo de Molina (2003).

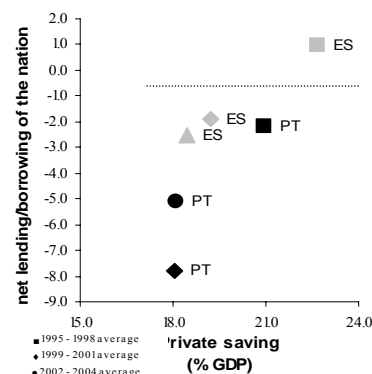
Graph IV.12. Competitiveness and external balance



Graph IV.13. Cyclically-adjusted primary balance (% of GDP)



Graph IV.14. Private saving and net lending/borrowing (% of GDP)



4.4 Quantifying risks to public debt sustainability

4.4.1 Volatility and public finances

The preceding discussion explored past economic and financial volatility, and went on to consider possible sources of future volatility – including in the course of financial sector convergence. A key aspect of the setting for fiscal policy lies in the potential impact on the public debt of volatility in key variables such as interest rates, exchange rates, and output as well as contingent liabilities

The impact of such developments on the recently acceded Member States is strikingly diverse. Starting levels of debt are very low in some cases – but in others shocks to the public debt could result in serious risks to private confidence and thus to strong and sustained growth. This sheds light on the complementarities and trade-offs facing fiscal policy. This section considers these issues in the framework of a standard debt dynamics equation, and presents an overview of contingent liabilities. It thus pulls together a number of strands in the discussion so far, and sets the stage to consider policy priorities.

A country's public finances are sustainable¹⁵² if it is able to continue servicing debt without unrealistically large adjustment efforts. Thus sustainability is not associated with a particular debt ratio, but is conditional on a number of factors, some of which are not under the full control of the authorities. Key factors include the cost of market financing, policy with respect to income and expenditure, and variables such as growth, inflation and the exchange rate. Vulnerability is the risk that debt sustainability can only be maintained with large

corrections to the balance of income and expenditure which are socially or politically difficult to bear.

Stress tests are valuable in assessing the vulnerability of the debt position to potential shocks. With a standard debt dynamics equation (see Box IV.2) one can examine the relative importance of the main driving forces of public finances, under conditions of uncertainty. The sensitivity of the debt position is analysed by applying a series of shocks to the baseline. The shocks are assumed to be temporary, so that the relevant time horizon is the medium term (2005-2010).

Before turning to the nature of the shocks, the baseline has to be explained. It is assumed in the baseline that the debt GDP ratio does not change with respect to the year 2004. In other words, the baseline represents a constellation of macroeconomic variables which keeps the debt GDP ratio constant. This may in certain countries not be the most plausible scenario (see Commission Spring 2005 Forecasts), but it facilitates the analysis of the shocks. Where continuing fiscal deficits are projected, for example, baseline projections of the public debt would need to incorporate these.

Constructing the most useful type and size of shock poses difficult issues. Shocks should be sufficiently large to capture most of the risk. On the other hand, if the shock is too extreme, the likelihood of its occurrence is very small and not of great practical significance. The probability of a shock larger than two standard deviations from the mean is rather small (assuming a normal distribution the probability is about 2%). This suggests that two standard deviations shocks encompass most of the risks. A low sensitivity to such a shock is an indication of a certain degree of robustness of public finances.

¹⁵² For a full analysis see IMF (2002), "Assessing sustainability", 28 May. Assessing debt sustainability is a standard section in the IMF's Article IV evaluations.

Table IV.7. Macroeconomic and public finance performance and volatility in the recently acceded Member States

| | CZ | EE | CY | LV | LT | HU | MT | PL | SI | SK |
|---|------|------|------|-----|-----|------|-----|------|------|------|
| annual average 1997 – 2004 | | | | | | | | | | |
| Real GDP (% change) | 1.8 | 6.1 | 3.6 | 6.7 | 5.7 | 4.1 | 2.4 | 3.9 | 3.8 | 3.8 |
| GDP deflator (% change) | 4.8 | 5.9 | 2.9 | 4.4 | 2.7 | 10.2 | 2.5 | 5.9 | 6.8 | 5.5 |
| Primary deficit (% of GDP) | 4.4 | -0.8 | 0.7 | 1.0 | 1.2 | 1.0 | 2.9 | 0.7 | 0.3 | 3.2 |
| Implicit interest rate on debt (%) | 6.7 | 6.5 | 5.7 | 7.7 | 7.2 | 9.0 | 6.4 | 7.4 | 9.0 | 8.2 |
| Exchange rate (USD/domestic currency,% change) | 1.3 | 0.0 | 0.4 | 0.5 | 4.9 | -2.7 | 0.8 | -3.3 | -3.7 | 0.1 |
| annual standard deviation 1997 – 2004 | | | | | | | | | | |
| Real GDP (% change) | 2.0 | 3.0 | 1.3 | 1.8 | 3.4 | 0.7 | 2.9 | 1.9 | 1.0 | 1.3 |
| GDP deflator (% change) | 3.4 | 2.6 | 1.0 | 1.5 | 5.0 | 3.8 | 1.6 | 4.8 | 1.9 | 1.5 |
| Primary deficit (% of GDP) | 3.0 | 2.0 | 1.5 | 2.0 | 1.3 | 2.9 | 1.8 | 0.8 | 0.4 | 2.3 |
| Implicit interest rate on debt (%) | 2.4 | 1.3 | 0.4 | 1.2 | 1.0 | 1.1 | 0.7 | 1.1 | 1.4 | 1.5 |
| Exchange rate (USD/domestic currency % change) | 11.8 | 11.4 | 10.3 | 4.8 | 7.5 | 13.4 | 8.1 | 9.2 | 11.5 | 13.2 |

Source: Commission services.

The sensitivity of the debt/GDP ratio is examined here with respect to six shocks: (i) The historical averages for the key variables observed are substituted in the period 2005-2010 to check the realism of the baseline scenario of an unchanged debt ratio; (ii) A negative shock to GDP growth. (iii) A rise in the interest rate. (iv) A negative shock to the primary balance. (v) A depreciation of the domestic currency by 25 % against all the other currencies. (vi) A combination of shocks (ii), (iii) and (iv) to which is added shock (v) in the case of floating currencies (Czech Republic, Poland and Slovakia). The historical averages are calculated on the available data for the period 1997-2004 and the standard deviations as well (see Table IV.7).

For shocks (ii)-(iv), the simulations concern two standard deviations from the historical mean, applied to two consecutive years (2005-2006), followed by a return to the baseline constellation. The justification for a fixed depreciation (shock (v)) in a particular year (2005) is that in fixed rate regimes the volatility of the exchange rate may be rather low (resulting in a small standard deviation). The motivation for shock (vi) is that usually shocks do not occur in isolation; this combined shock can be considered a worst case scenario.

As regards the vulnerability of budgetary developments, there are marked country differences. The Baltic States (Graph IV.15) are characterised by low debt levels which make public finances in general less sensitive. Vulnerability to growth variations, as well as interest rate volatility is low. If the recent past were to recur, debt developments would remain benign on the whole; only in Latvia would the debt GDP ratio increase to a certain extent on account of lower growth, a higher primary deficit, but also lower inflation which have been observed in the reference period compared to 2004.

In the Baltic states, sudden shocks to the primary balance represent the largest risk. Compared to the other EU-10, the impact is not negligible. Given high shares of foreign currency debt in total debt (more than 90 % in Estonia, about 75 % in Latvia and 60 % in Lithuania), the public finances would be vulnerable to a depreciation. However, the solid track record of the these countries, which have now all joined ERMII, makes such an event rather implausible. In a 'realistic' worst case scenario where growth would be significantly lower, the primary balance wider, the interest rate higher, but the exchange rate peg would be maintained, the debt ratio would nonetheless increase considerably.

Higher debt/GDP ratios make the public finances in the four large new Member States (Graph IV.15) more vulnerable than in the Baltic States. The proximity of the 60 % reference value (particularly in Hungary) adds to the concerns. Based on experience in 1997-04, notably a small and stable primary deficit (Table IV.7), the Polish public finances appear more shock resistant than those of the Czech Republic, Hungary and Slovakia, but remain more sensitive to variations in output and interest rates than the Baltic States. However, recent difficulties with consolidation in Poland, and notably with the implementation of the Hausner plan, invite some caution.

Debt developments in Hungary would in theory be favourable in the medium term if historical macroeconomic conditions occurred again. But it is unlikely and undesirable that the high inflation rate (the average GDP deflator was 10.2 % in 1997-04, Table IV.7), which was one of the drivers of the favourable debt dynamics in Hungary, would recur.

Box IV.2. Determinants of the debt/GDP ratio

The standard debt equation reads as follows:

$$D_{t+1} = (1 + i) D_t + \varepsilon \alpha (1 + i) D_t - PB_{t+1} + OD_{t+1}$$

Where

- D: total general government debt;
 i: nominal interest rate on debt (total interest divided by outstanding debt in previous year);
 ε: depreciation of the domestic currency (indicated by an increase in the exchange rate expressed as units of domestic currency for one unit of foreign currency);
 α: share of foreign currency debt in total debt;
 PB: primary balance, equal to primary expenditure (PE) minus total receipts (TR);
 OD: other debt, including privatisation (reduces debt), debt assumption by the state;
 t: (subscript) time dimension of the variables; variables without time dimension are in t + 1.

Dividing the debt equation by GDP_{t+1} and some re-arranging in order to obtain the determinants of the change in the debt/GDP ratio results in:

$$\begin{aligned} d_{t+1} - d_t &= \frac{(i - \pi)(1 + g)}{(1 + \pi)(1 + g)} d_t && \text{(real interest rate)} \\ &- \frac{g}{(1 + \pi)(1 + g)} d_t && \text{(real GDP growth)} \\ &+ \frac{\alpha \varepsilon (1 + i)}{(1 + \pi)(1 + g)} d_t && \text{(exchange rate)} \\ &- \left[\frac{(1 + g_{pe})}{(1 + \pi)(1 + g)} pe_t + \frac{(1 + g_{tr})}{(1 + \pi)(1 + g)} tr_t \right] && \text{(primary balance)} \\ &+ od_{t+1} && \text{(other debt)} \end{aligned}$$

Where

- d, pe, tr, od: (small letters) debt, primary expenditure, total receipts, other debt as % of GDP
 π: GDP deflator
 g: real GDP growth
 g_{pe}, g_{tr}: nominal growth of primary expenditure and total receipts

In the Czech Republic, Poland and Slovakia, a recurrence of past conditions would lead to a sharp increase in the debt ratio – in the Czech Republic and Slovakia, even beyond the 60% reference value. (Table IV.8)

High interest rates are a source of vulnerability in Hungary – as well as volatility of the exchange rate, because of the large share of foreign currency (about 33 % of total debt). In Poland also a depreciation would weigh on public finances despite the considerable reduction of the foreign currency share in total debt from about 55 % in 1997 to 30 % in 2004. Exchange rate volatility is less of an issue in the Czech Republic, where foreign currency debt represents only 5% of total debt, and in Slovakia where the foreign currency share is limited to about 20 %. Output swings could be a concern in the Czech Republic and Poland. Difficulties in containing primary expenditure, and hence the primary balance, appear for all four countries (including Poland based on recent developments) the largest source

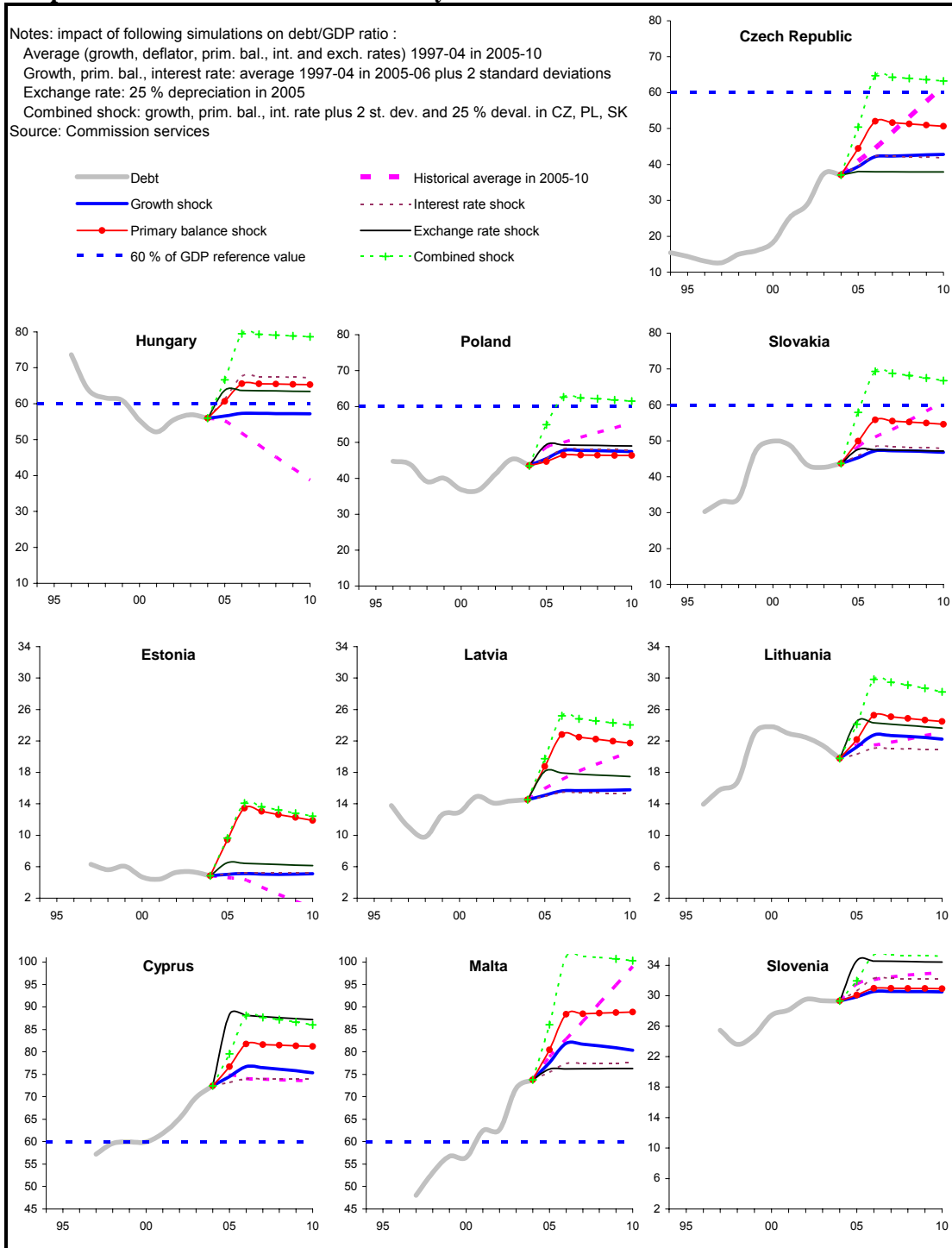
of vulnerability. The sensitivity of the public finances is further highlighted if several shocks would occur at the same time, including a depreciation of the currency in the case of the Czech Republic, Poland and Slovakia.

Among the EU-10, the two islands have the highest debt ratios. The Maltese public finances, in particular, appear vulnerable if the output volatility and relatively high primary deficit observed in the past were to occur again. The outlook would remain benign in Cyprus if recent developments in the economy and in the primary balance were to continue. Nevertheless, if the past debt increasing stock-flow adjustments would become a feature of the future, the benign outlook may have to be qualified. Due to the high foreign currency share in total debt (about 55 %) Cyprus is sensitive to a depreciation of the currency, while this is not an issue in Malta (foreign currency debt is about 7 % of total debt). However, exchange rate vulnerability has to be assessed in the light of the good track record of currency stability in the two countries.

Slovenia has a low debt and is the most stable economy among the new Member States – with only a small primary deficit in the period considered here, and relatively stable government expenditure and revenue flows. It had, however, an inflationary past leading to high interest rates and a continuous depreciation of the currency. With the successful EMU entry in June

2004, there came an end to this type of uncertainty. In consequence, the vulnerability to exchange rate volatility stemming from the relatively high share of about 55 % of foreign currency debt in total debt, is mitigated. Even in a worst case scenario, vulnerability of public finances appears contained.

Graph IV.15. Stress tests for the recently acceded Member States



4.4.2 Contingent liabilities in the recently acceded Member States

The EU-10, like many other countries, face major fiscal risks as a result of contingent liabilities which are not recorded in government debt or effectively captured in budget documentation. While the ESA95 definition of the government debt, like most such definitions, includes government obligations backed by law and that will arise in any event, contingent liabilities are obligations that are triggered by the occurrence of a specific but uncertain event. In general, such liabilities are politically more attractive than budgetary support, as their fiscal cost remains invisible until they are realized. However, they increase risks for the public finances in the long run. Quite often, contingent liabilities may arise from fiscal opportunism. As they strive to comply with the requirements of the Stability and Growth Pact and target a reduction of their government deficits below the reference value of 3% of GDP, some of these countries may be tempted to shift part of the budgetary cost of their policies to the future by using contingent forms of government support. The analysis of fiscal risks stemming from such liabilities is particularly relevant for the EU-10 as they tend to accumulate obligations outside the budgetary framework. There are several types of contingent liabilities which may threaten the stability of the public finances. They can be either explicit or implicit, depending on the existence of a legal basis.

Explicit contingent liabilities are government obligations defined by law or contract that arise only if a particular event occurs. *State guarantees* and financing through *state-guaranteed institutions* represent the most prominent form of explicit contingent liabilities in the EU-10. State guarantees can be either credit guarantees to state-owned companies or private entities, or government guarantees issued on debt or other obligations of local governments. Other types are statutory guarantees on liabilities of financial institutions, or state guarantees issued to private sector investors and service providers. *State insurance schemes* are another common example of explicit contingent liabilities in the EU-10. In Lithuania, deposit insurance schemes represent a significant source of contingent liabilities. Also, nearly all the recently acceded Member States that undertook extensive pension reforms (Estonia, Hungary, Poland and Slovakia) have provided insurance schemes to private pension funds, guaranteeing to pensioners minimum benefits or minimum returns on their contributions. Finally, in some countries (Poland and Slovakia), contingent liabilities stem from *litigation* cases, often concerning the restitution of property taken by the State or arising from privatisation or restructuring.

Implicit contingent liabilities are obligations triggered by uncertain events which do not have a legal basis, but may arise as a result of expectations created by past

practice or political pressures. A common example is the bail-out of defaulting public sector or private entities (e.g. state-owned companies, local governments, banks or other financial institutions such as pension and social security funds or credit and guarantee funds). Other forms of implicit contingent liabilities identified in the new Member States are possible obligations related to environmental damage (e.g. decommissioning of the Ignalina nuclear power plant in Lithuania) and non-contractual claims arising from private investment, for instance in infrastructure (e.g. possible claims arising from public-private partnerships for motorway construction in Hungary).

Table IV.8 provides an overview of contingent liabilities in the EU-10, together with a tentative estimate of their potential fiscal costs, based on the information reported in the December 2004 updates of the convergence programmes. Overall, state guarantees appear to constitute the main source of fiscal risk in most EU-10. The stock of government guarantees is particularly high in Malta (17% of GDP), Cyprus, the Czech Republic and Slovakia (10% of GDP), and somewhat lower in Slovenia (7.5% of GDP) and Hungary (around 5.5% of GDP). In the past, transition and privatisation have contributed to the accumulation of public guarantees and other off-budget support in the former centrally-planned economies. As restructuring and privatisation are typically far advanced, the stock of guarantees will likely start to fall. However, in Poland, contingent support to state-owned companies in the sectors in need of restructuring (i.e. in coal mining, steel industry and railways) are expected to remain a significant source of risk in the coming years.

Although transition is no longer a major source of contingent liabilities, new sources of risk have emerged in the recent period. In particular, Polackova Bixi (2004) has highlighted two factors that will likely lead to increased risk exposure in future: the need to close the infrastructure gap, and fiscal decentralisation. First, many recently acceded Member States tend to promote private participation in financing infrastructure investments by establishing public-private partnerships. However, experience shows that these frequently require government support through explicit guarantees or other disguised subsidies. Second, the growing autonomy and involvement of local governments in promoting regional development may generate contingent liabilities. Most EU-10 have established strict limits on local borrowing, but forms of off-budget finance are available. These contingent liabilities as well as the debt of local governments often expose the central government to risk.

In recent years, the new Member States have achieved a number of improvements in recording and monitoring contingent liabilities. In accordance with ESA95 requirements, all have made considerable progress in incorporating the activities of extrabudgetary funds and off-budget agencies into the general government, thus

converting their liabilities from contingent to direct liabilities for the government. Also, these countries have made efforts to reveal and assess fiscal risks emerging from state guarantees. The Czech Republic and Slovakia have assessed most or part of their outstanding government guarantees as risky and have reported their full value as government debt (ESA95 definition). In the case of Poland, the risk-weighted stock of outstanding guarantees is included in the public debt (national

definition). Other countries, like Hungary, provide detailed information on the expected cost of the guarantees in the documents attached to the budget. Moreover, in most countries, the volume of guarantees issued by the government is limited by law. Nonetheless, effectively capturing contingent liabilities in the fiscal framework and assessing related fiscal risks remains a key challenge for these countries.

Table IV.8. Contingent liabilities in the recently acceded Member States

| | Explicit (government obligation created by law or contract) | Implicit (government obligation arising from public expectations or political pressures) |
|----------------|---|---|
| Cyprus | <ul style="list-style-type: none"> State guarantees on borrowing provided to semi-government organisations and domestic institutions (10% of GDP) | |
| Czech Republic | <ul style="list-style-type: none"> State guarantees (10% of GDP) and liabilities of the Czech Consolidation Agency (CKA) (7.5% of GDP) – included in the ESA95 government debt State guarantees (0.7% of GDP) – not included in the government debt | <ul style="list-style-type: none"> Liabilities of the National Property Fund associated with the removal of ecological damage in privatised properties Bailouts related to hospital arrears |
| Estonia | <ul style="list-style-type: none"> State guarantees (3.3% of GDP) – student loans, export guarantees, loan contracts | |
| Hungary | <ul style="list-style-type: none"> State guarantees (5.4% of GDP) – including guarantees to the Hungarian Railway Company | <ul style="list-style-type: none"> Potential liabilities arising from public-private partnership arrangements (motorway construction, construction of student hostels and prisons) |
| Latvia | <ul style="list-style-type: none"> State guarantees (2.1% of GDP) | |
| Lithuania | <ul style="list-style-type: none"> Government-guaranteed loans (2% of GDP) Credit guarantees to SMEs Deposit insurance (25.6% of GDP) Restitution of rouble savings and property rights (4.4% of GDP) | <ul style="list-style-type: none"> Municipal budget arrears (0.4% of GDP) Decommissioning of the Ignalina nuclear power plant |
| Malta | <ul style="list-style-type: none"> State guarantees (17% of GDP) – mainly to public sector entities | |
| Poland | <ul style="list-style-type: none"> State guarantees (3.9% of GDP) – mainly to state-owned companies Litigation (legal claims concerning 1944-1962 property losses: 6.6% of GDP) | <ul style="list-style-type: none"> Debt relief in the health sector (0.7% of GDP) Potential liabilities arising from the restructuring of industries (railways, coal mining, steelworks) Possible claims arising from private investment in infrastructure (motorway construction co-financed by International Financial Institutions) |
| Slovakia | <ul style="list-style-type: none"> State guarantees (approximately 10% of GDP) – out of which more than half included in the ESA 95 government debt Litigation (legal claims by Českoslovenka Obochdni Banka and the Slovak Gas Company) | <ul style="list-style-type: none"> Debt relief in the health sector |
| Slovenia | <ul style="list-style-type: none"> State guarantees (7.5% of GDP) – mainly to public sector entities for the financing of infrastructure and export guarantees | <ul style="list-style-type: none"> Debt of state-controlled financial institutions and their guaranteed debt to third parties (4.1% of GDP) |

Note: The figures refers to the outstanding stock of state guarantees and other contingent liabilities at the end of the 2003.

Source: December 2004 updates of the convergence programmes, Commission services, Polackova Brixl (2004).

5. Fiscal policies for stable convergence

5.1 Introduction

Major progress has been achieved in strengthening the public finances of the recently acceded Member States – most strikingly so in cases where systemic transformation was required in the transition from central planning. Significant challenges still lie ahead during the course of steep real and (in most cases) financial convergence, and as the EU-10 move at varying speeds toward euro adoption. This section discusses several issues for fiscal policy that arise in this setting.

First, it will be important to assure scope for growth-supportive expenditure priorities, while exploiting the scope to achieve fiscal savings by reforming existing programmes – an approach evidenced in various ways in the recent Convergence Programmes of the new Member States.

Second, medium-term fiscal plans need to assure public debt sustainability, keeping in mind the possibility of future shocks to the economy and the public finances. Most of the recently acceded Member States face major demographic challenges: they are typically moving to address these through growth-oriented approaches based on structural reform of pension systems – though action is still needed in some cases, and supportive labour market reforms are also crucial.

Third, those new Member States with developing financial sectors may face extended periods of rapid credit expansion and wide private sector imbalances. It is important not to overestimate underlying trends in potential growth or in revenues: an unintentionally procyclical stance could run external financing risks, and limit the scope for fiscal flexibility during a subsequent slowdown.

Fourth, monetary and exchange regimes influence the way that risks for policy crystallize. In the run-up to euro adoption there are special demands on market credibility and the macroeconomic policy mix during a

period of exchange rate targeting. If, on the other hand, national currencies are retained for an extended period, it will remain important to guard against a build-up of risks through unhedged foreign currency borrowing by the non-bank private sector (which could be accelerated by high domestic interest rates associated with fiscal tensions). Under the euro, exchange rate risks disappear, but external adjustment challenges do not: sound fiscal policy in ‘good times’ can increase flexibility at times of setbacks to growth.

Fifth, there are questions how to address possible market tensions during convergence – including the risk of a loss of access to international capital markets, or of market pressures in the run-up to euro adoption. Responding to shocks and emerging risks through discretionary fiscal adjustment has costs, such as the risk that budgetary cuts fall on investment. This argues for setting prudent medium-term goals, with adequate safety margins. But it also highlights the case for strengthening fiscal institutions – and thus improving the underlying trade-offs for policy.

Finally, the situation in the public finances differs widely across the EU-10. Encouragingly, those economies which face the tougher fiscal deficit and debt challenges may also have the greater scope to meet these through structural fiscal reforms that are themselves growth-enhancing. Effective fiscal strategies need to be developed on a case-by-case basis, and the Convergence Programmes will continue to provide a valuable vehicle for this.

5.2 Tax and expenditure strategies consistent with stable convergence

There is wide consensus that fiscal policy can make a contribution to potential growth through supply-side effects.¹⁵³ The strong catching-up potential of the EU-

¹⁵³ See, e.g., Bleaney et al. (2001), Kneller et al. (1999) for an empirical analysis of OECD countries and Romero de Avila

10, and the need to complete restructuring, suggest that the public finances can provide a powerful support in this regard. So far, total factor productivity and capital accumulation have been key sources of growth. In the period ahead both will remain important, while – with the right skills available, and sufficient mobility – labour input should shift toward a positive contribution.

To support this process, the public sector needs to commit adequate resources for key priorities such as infrastructure investment, and education and training. Policy-makers should also be mindful of research and development needs, while taking full account of rates of return and the role of the private sector. Pension reforms can improve employment incentives and the profile of the public finances, and these too entail upfront costs. It is the need to assure adequate financing for such areas that has raised questions whether growth would be enhanced by tolerating wider fiscal deficits (e.g., Buiter and Grafe (2002)). Indeed, the important medium-term contribution of pension reforms has led to their special treatment under the revised Stability and Growth Pact (Box IV.3).

A second element in support for growth is the incentive effects and signals to the private sector that result from structural features of policy. These can enhance the setting for investment and job creation. Taxation needs to be broad-based and to avoid distorting economic activity. Tax and social security charges together should not represent an unduly heavy burden on labour income. Marginal rates of taxation and benefit withdrawal need to avoid discouraging employment. Well-targeted benefits can facilitate restructuring by easing adjustment strains. And transfers to firms that distort resource allocation need to be phased out. A number of these approaches can increase public savings even in the short run. It would thus be wrong to equate growth-oriented reform of the public finances, mechanically, with a net widening of fiscal deficits.

In this connection, key features of the composition of public finances in new Member States, as these emerge from Section 3 above, can be summarised as follows:

- Despite a cut in taxes on capital and labour over the past decade, the total burden on labour often remains high compared with other countries of similar per-capita income.
- Primary expenditure as a share of GDP in the central European new Member States (except Slovakia) and the island economies is in the same range as in euro area members, despite substantially lower income levels. This contrasts with the Baltic states.

- Collective consumption and employee costs are relatively high (including in the Baltic states) – suggestive of over-staffing.
- Cash social transfers do not exceed the euro area level, but show wide variations across the EU-10. Some countries like Poland and Slovenia exhibit high shares compared with other countries with similar income per-capita.
- Subsidies are fairly high in some cases, but the picture is very differentiated across countries.

Both the relatively high GDP-share of certain key expenditure categories and the variation of these shares across countries suggest, at least *prima facie*, that there is still scope for revenue and expenditure rationalisation, in particular in the central European new Member States.

However, this pattern also highlights that expenditure challenges cannot be reduced to a rule-of-thumb formula, or just achieved through a compression of rates of pay. The nature of the expenditures that could be reduced suggests that structural reforms are required. Similarly, it is tax bases, not tax rates, that need to be strengthened. Countries, moreover, show major differences: tailor-made approaches are called for. And given the structural nature of the challenges, this may imply a multi-year approach.

On the revenue side, most recently acceded Member States have been reducing personal, and especially corporate, income tax rates with the aim of supporting private sector growth. While this trend is likely not to continue at the same pace, it is also not likely to be reversed. Notably, most new Member States still have high taxation of personal incomes, typically resulting from social security contributions on wages and salaries higher than in other countries with similar income per-capita, including EU cohesion countries. Moreover, in some of the EU-10 (Hungary, Poland, Slovakia) pension reforms introducing funded pillars will cause a loss of contributions for the government (since these are to be recorded outside the government sector according to the 2 March 2004 Eurostat decision after a transition period).

Room for increasing revenues efficiently, however, can be found in several areas. Excise rates can be raised in line with typically higher rates in the former EU-15. Savings can also be achieved by expanding the tax base and rationalising the tax system. Stronger tax administration may increase collections, especially of VAT. Revenue sources can be broadened via the introduction of taxes on bases that are not taxed or taxed at a low rate, and also by reducing exemptions and preferential rates – especially for indirect, but also for direct taxes. While VAT rates are relatively high compared with the former EU-15 countries, there are more exemptions and reduced rate items. There is also rather extensive recourse to tax expenditures for

and Strauch (2003) for an application to EU countries. European Commission (2004a) provides a literature survey.

personal and corporate income tax rates, i.e., exemptions to promote goals similar to those of traditional expenditures. Moreover, gains could be obtained by reducing the amount of ‘revenue churning’ associated with overlapping income transfer flows via preferential taxation, and social transfer schemes (Cavalcanti and Li (2000), Burns and Yoo (2002a, 2002b)).

On the expenditure side, there are some constraints that affect potential reforms to increase savings: accession

related expenditures (including those in connection with environmental standards, transport infrastructure and administrative costs), the need to improve infrastructure throughout the catching-up process, and the impact of population ageing, which (even with pension and health reforms) will trigger pressures on social security systems over time. Moreover, healthcare spending is generally no higher than in the other cohesion countries.

Box IV.3. The Stability and Growth Pact – 2005 reform package and its Consequences for recently acceded Member States

The agreement on a reform of the SGP endorsed by EU Heads of State and Government on 22 March 2005 introduces more economic rationale and greater differentiation reflecting the increased economic heterogeneity in the enlarged EU of 25 Member States. While all changes introduced by the reform will of course apply to the EU-10, the following elements of the reform are of particular importance:

Country-specific medium-term budgetary objectives. The reform foresees that Medium-Term budgetary objectives (MTO) will be differentiated across countries according to their debt ratio and potential growth (and later, sustainability of government finances). This has a clear implication for the new Member States, which in many cases have relatively low debt ratios and high potential growth, and may therefore need to pursue less ambitious MTOs, to comply with the reformed SGP, than would have been the case previously. The reform specifies that new Member States participating in the ERM-II (and, later, in the euro area) will have a MTO in a range between -1% of GDP for countries with low debt and high potential growth, and balance or in surplus for countries with high debt and low potential growth; if they have not achieved the MTO, they should pursue, as a benchmark, an annual adjustment of 0.5% of GDP, net of one-off and other temporary measures. For EU-10 not participating to ERM-II, the MTO will be set at a level providing a safety margin with respect to the 3% of GDP deficit limit, ensuring rapid progress towards sustainability, and allowing room for budgetary manoeuvre, in particular taking into account the needs for public investment.

Deeper and more differentiated assessment of budgetary developments in the excessive deficit procedure. The new agreement specifies a set of ‘other relevant factors’ that the Commission and the Council will take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction. These factors include, inter alia, developments in potential growth but also considerations with respect to debt sustainability, and can be taken into account in all the steps of the excessive deficit procedure (except abrogation). For the same reasons as mentioned above, this may be relevant in the case of the recently acceded Member States. The reformulation of the exceptionality clause of a ‘severe economic downturn’ is also important for EU-10. Both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit may consider an excess above 3% as exceptional as long as it remains ‘close to the reference value’ and ‘temporary’ and if it results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth. While EU-10 have usually higher potential growth and should only extremely rarely face periods of negative growth, they may, as other Member States face protracted period of very low growth.

Taking into account systemic pension reforms. The Commission and the Council, in all budgetary assessments in the framework of the EDP, will give due consideration to the implementation of these reforms. This is particularly relevant for EU-10 since several of them have introduced such reforms in the recent years or plan to introduce such reforms. The agreement stipulates in particular that an excess close to the deficit reference value which reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully-funded pillar, should be considered carefully. Consideration to the net impact on the EDP deficit of multi-pillar pension reforms will be given for the initial five years after a Member State has introduced a mandatory fully-funded system, or five years after 2004 for Member States that have introduced such a reform before 2005, in a regressive way over five years. This is potentially important for decisions on the euro adoption.

Substantial savings, however, can be found in containing wage dynamics and limiting the growth of health expenditures and social transfers. The first typically requires structural approaches along the lines of civil service reform and/or a hiving-off of functions. On average, earnings of public employees have been lower in the EU-10 than the EU cohesion countries (Funck (2002)). Moreover strong dynamics in private sector earnings will increase upward pressures on pay scales (Kohler-Toghofer, Baecke, and Schardax (2003)). In health care, most gains are to be found through more effective expenditure control mechanisms and improved cost efficiency. In pensions, reform of

social security systems recently implemented in most EU-10 will contribute to contain the increase in benefits associated with ageing populations – though further action may be needed in some countries to ensure dynamics of pension payments consistent with budgetary objectives.

Importantly also, the discussion above pointed to the scope for curtailing subsidies to firms and rationalizing transfers to persons – including through a better targeting of benefits. The former can imply significant adjustments in the real economy, while well-targeted social transfers can to some degree ease the strains associated with such adjustments.

The updated convergence programmes of the EU-10 set out priorities for tax and expenditure reform, as well as consolidation goals. They reflect several strategic concerns: the scale of adjustment to respect the Maastricht deficit criterion; the need to support private sector growth during catching up (e.g., containing the tax burden on capital and labour); phasing out subsidies and ‘extra-budgetary’ funds; and adaptation of institutions and services to changing conditions (e.g., pension, health and education reforms).

In their updated programmes, all of the EU-10, with the exception of Lithuania and Latvia, plan to cut expenditures over the programme horizon (see Table IV.10). While the Czech Republic, Estonia, Hungary and Malta plan to reduce the government revenues/GDP ratio, others base their strategy on higher revenue shares. Among those currently in the Excessive Deficit Procedure which committed to ambitious consolidation paths, strategies differ. Cyprus and Poland foresee increases in revenues relative to GDP, while Hungary and Malta foresee a decline.

Updated Convergence Programmes indicate that cuts in expenditures are expected especially in terms of lower

collective consumption, and cash and non-cash social benefits. Savings in collective consumption (mainly government wage bills) are foreseen especially in the Czech Republic, Estonia and Hungary. Ambitious health reform packages have been announced in the Programmes of Hungary and Cyprus. Social transfers are planned to be reduced considerably, especially in Poland, Malta and the Czech Republic.

On the revenue side, plans are broadly consistent with the considerations discussed above. Improvements associated with enhanced tax administration and rationalisation of the tax system, for example, are foreseen in Poland, Lithuania, Estonia and Hungary.

Finally, when assessing the impact of convergence priorities on deficits and the public debt, account needs to be taken of the availability of EU budgetary transfers. Such transfers should help substantially in financing growth-enhancing expenditures (Hallett (2004); Hallett and Keereman (2005)). Together with the volume of co-financing and fully nationally financed expenditures, however, they may in some cases test the limits of absorption capacities; and they do not fully offset the external impact of associated public expenditures.

Table IV.9. Projected change in government revenues and expenditures over the 2004-2007 period (changes over the programme horizon in, respectively, the government revenue/GDP ratio and the government expenditure/GDP ratio are indicated in parenthesis)

| Government revenues/GDP Government expenditures/GDP | Cut | Increase |
|--|---|---|
| Cut | CZ (-1.8, -3.7), EE (-3.5, -2.5), HU (-1.2, -3.7), MT (-1.8, -5.6) | CY (+1.6, -2.3), PL (+0.8, -2.4), SK (+0.5, -0.3), SL (+0.2, -0.8) |
| Increase | | LT (+1.5, +0.5), LV (+0.8, +0.5) |

Source: 2004 Convergence Programme updates.

5.3 Debt sustainability and ageing

Credible fiscal policy can help ensure that convergence is not interrupted by financial or real sector stress, and that investment is not held back by risk perceptions in the private sector. In this respect, the most fundamental requirement is to target a primary balance that assures satisfactory debt dynamics in terms of a public debt ratio that declines rapidly to – or remains below – the Treaty value of 60 percent of GDP.

Discussion earlier in this chapter highlighted risks to the public debt that could arise from volatility in key real and financial variables. Among these is the possibility that future stresses during the expansion and transformation of the real and financial sectors could add to contingent liabilities. In all economies it is prudent to allow public debt headroom for possible shocks. Among the EU-10, this is operationally most important in the larger economies of central Europe –

given present debt ratios, the extent of future economic and financial transformation, the relatively high stock of contingent liabilities, and the sensitivity of debt levels to shocks originating in the real and financial economy. The extent of headroom below the 60% debt ratio that is prudent on these grounds is an issue to be evaluated on a case-by-case basis.

The long run sustainability of the public finances embraces broader issues, some of which cannot be assessed in isolation from strategies for structural reform. A key issue in this respect is population ageing – and this is an area in which the underlying demographic situation and prospects of the EU-10 is typically unfavourable (Box IV.4). Experience so far supports the view that the new Member States will opt for growth-friendly strategy, based mainly on structural reforms rather than higher primary surplus. But to contain risk in the economy, far-reaching action is still needed in some cases (Graph IV.16). More generally, credible progress will need to be kept up in

implementing reforms under way, and flanking measures are typically needed in the labour market.

5.4 Stabilizers and credit cycles

The stabilizing role of fiscal policy also operates through the role of the public sector saving-investment balance in dampening economic fluctuations – including by ensuring a sound macroeconomic policy mix. The core requirement in this regard, common to all Member States, is to create sufficient room for manoeuvre for the free play of automatic stabilizers over the business cycle without endangering policy credibility or SGP limits (Box IV.5).

A more difficult issue, during catching up, is how fiscal policy should respond to strong cycles in private sector activity, lasting much longer than typical business cycles and frequently associated with rapid credit growth. These could give rise to sizable external imbalances, with the counterparts being some mix of household consumption and private investment. This has been illustrated in the Baltic states, where large external current account deficits have been wholly or partly driven by the private saving-investment imbalance, associated with strong credit growth. Ultimately, the impact of such cycles on sustainable growth will depend on factors that reflect the frameworks for private sector decision-making – the sound allocation of resources and prudent appraisal of funding risks. Nonetheless, the discussion in section 4 of this chapter, with the aid of two country examples, highlighted the role that the

public sector balance can play in moderating such cycles and assuring resilience during down-turns. Its impact depends in part, of course, on the size of the sector relative to the economy.

This role of fiscal policy in dampening longer cycles during convergence depends on policy-makers avoiding pro-cyclicality by correctly analyzing elements in fiscal performance that are permanent as against those that are transient. This is relevant not only as regards the potential growth rate but – as recent literature has highlighted – concerning the performance of revenues relative to GDP during a strong private sector boom, especially where asset prices are rising strongly (Jaeger and Schuknect (2004)). Fiscal receipts are frequently swollen by factors that reflect the ongoing credit and asset price boom: capital gains levies, securities transactions taxes, etc. The impact on revenues of booms related specifically to asset prices has been estimated at levels of perhaps 1 percent of GDP. During such periods it could be prudent to aim for a higher nominal surplus (or lower deficit) on this account.

More generally, of course, where growth is well above its medium-term trend, this is also an opportunity to accelerate fiscal consolidation toward medium-term goals. And where there is a risk of downside shocks – such as shake-out costs in the real or financial sector after a protracted boom, or risks of a loss of access to international capital markets – it could also be prudent to allow for these in setting medium-term goals.

Box IV.4. Long-term sustainability of public finances in the new Member States

Demographic projections show a particularly troubling outlook in the EU-10. At present, most have relatively low fertility rates and lower – though increasing – life expectancy at birth than the EU-15, and frequently also a negative migration balance. The age profile is typically more favourable, but the situation is expected to worsen much faster on average by mid-century. While the average old-age dependency ratio of the EU-15 is projected to double by 2050, it is expected to more than double in Cyprus, the Czech Republic and Slovenia and even triple in Slovakia (Graph IV.16). These three countries and Poland are projected to face the most significant worsening in the dependency ratio among the EU-10. In other EU-10, on the other hand, the dependency ratio is forecast to be closer to or even below the EU average. Nevertheless, this outlook also implies serious consequences for the labour supply and growth unless a rise in total factor productivity compensates.

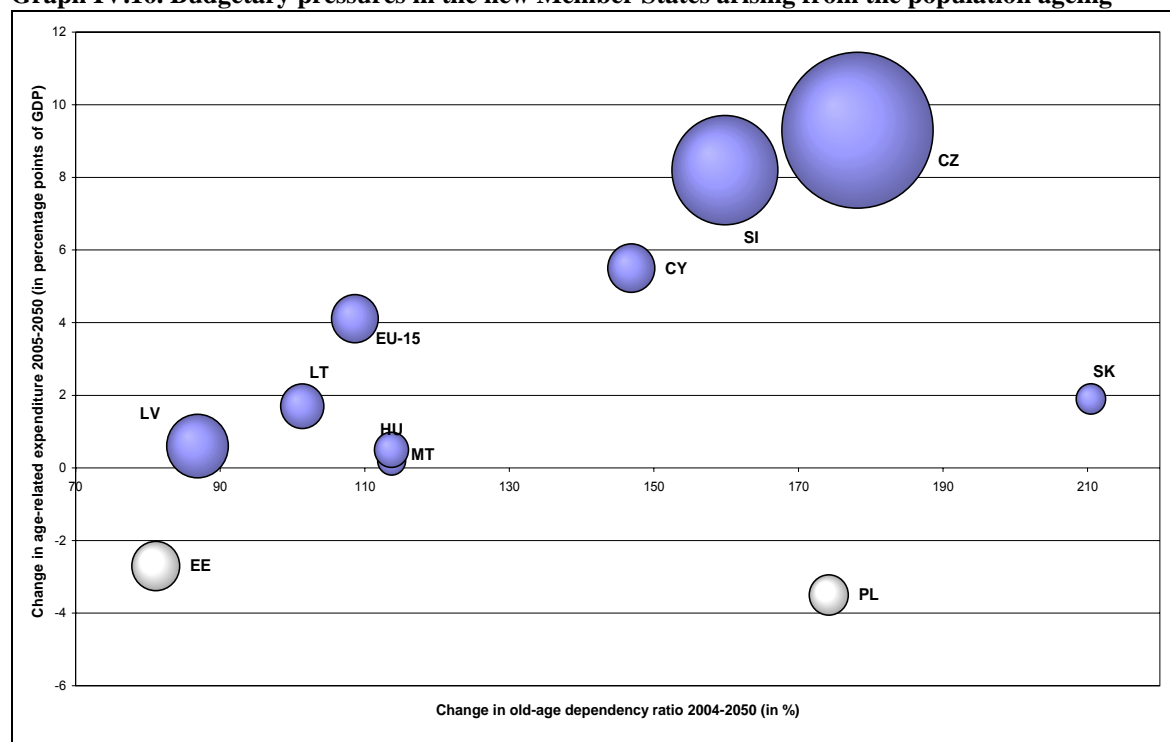
The budgetary impact, illustrated in the latest Convergence programmes, is a large increase in age-related spending in countries where old-age dependency ratios worsen most steeply, and in those that have not so far significantly reformed pension or health-care systems (Graph IV.16 – depicted by the location of the centre of the bubble in relation with the two axes). This is evident in the Czech Republic, Cyprus and Slovenia, although the parametric measures adopted in the latter in 2000 have mitigated risks. On the other hand, many new Member States have already implemented reform strategies in part or fully. In Slovakia, the ongoing pension reform is projected to result in a relatively low increase in spending compared with the Czech Republic. Estonia and Cyprus have similar dynamics in the old-age dependency ratio, but Estonia shows an actual decrease in pension and health-care system expenditures over time; and a similar outcome may result from reforms planned in Poland (once technical details are available).

Sustainability risks from ageing can be seen from long-term debt projections, assuming that medium-term reform plans in the convergence programmes are implemented. While the highest debt levels in 2050 (depicted by the width of the bubble) are projected in the Czech Republic and Slovenia, the debt level in Cyprus is, given the projected increase in age-related spending, relatively low. This is mainly due to a relatively high constant revenue level over the entire projection period. In line with the projected fall in the age-related expenditures in Estonia and Poland, the debt ratio would fall to zero.

Comprehensive reform strategies to contain age-related spending are beneficial for both debt sustainability and growth – requiring lower primary balances than otherwise. In this context, the EU-10 have made a considerable headway. Most of them have already introduced a three-pillar system, while others have adjusted parameters of their existing systems. To fully

contain budgetary risks, additional and simultaneous structural reforms, particularly in labour market policies, are required. Pension measures such as postponement of retirement and/or restrictions on early retirement require a setting of increasing employment and participation rates to absorb the labour force. Higher participation rates of older age people, a particular problem in the EU-10, as well as lower unemployment, can also mitigate the challenges of ageing populations.

Graph IV.16. Budgetary pressures in the new Member States arising from the population ageing



Note: Projected government debt in 2050 is depicted by the width of the circle. White colour indicates negative gross debt in 2050. For Cyprus, it concerns the adjusted gross debt.

Sources: Eurostat, News release 48/2005, 8 April 2005, 2004 updates of the stability and convergence programmes, Commission services calculations.

Box IV.5. The elasticity of fiscal balances to economic activity

Budgetary elasticities play an important role in assessing fiscal policy. They serve *inter alia* as an indicator for the strength of the countercyclical or stabilising effect of policy. Mainly because of data constraints there were no studies so far providing robust empirical estimates of budgetary elasticities in the EU-10 based on a common approach.

In 2004 OECD and Commission staff started work towards budgetary elasticities for the EU-10 following the more complex approach developed by van den Noord (2000). The elasticity includes two components. The first measures the impact of GDP on the tax base (or the macroeconomic variable more closely related with expenditure, e.g. unemployment in case of unemployment benefits). It is estimated econometrically using time-series data. The second component links the tax or expenditure base to the budgetary component, derived from tax legislation and related fiscal data.

Very preliminary results of the joint OECD and Commission estimation work, including an update of the elasticities for the EU-15, were made available at the end of 2004. Before commenting on the figures reported in the table below a couple of qualifications are in order. The presentation is limited to average tax and expenditure elasticities across groups of countries because of the preliminary nature of the estimates. Current results for all countries should thus be seen as work-in-progress.

Due to the lack of available data in the EU-10, the OECD methodology had to be adapted. In particular, the first component of the overall budgetary elasticity, which links the tax or expenditure base to GDP, was not derived from econometric regressions. By way of approximation, the OECD set it to the average of the small EU-15 countries. While this solution has the advantage of simplicity, it may be argued that countries undergoing major structural change are unlikely to exhibit elasticities similar to those of small open EU-15 economies. As an alternative, the Commission services estimated the first component of the budgetary elasticities for each individual EU-10 econometrically and took the average across countries.

On this basis, fiscal balances in the EU-10 show on average a lower sensitivity to the cycle than in the EU-15. This reflects the lower progressivity of income taxes and their lower share in total revenues; less generous unemployment insurance; and labour market variables that are less responsive over the cycle, though there are some reservations on econometric robustness.

A further conclusion concerns the stabilising effect of the budget over the cycle. In addition to lower budgetary elasticities, the EU-10 have on average a smaller size of government than the EU-15, as measured by the expenditure-to-GDP ratio. Since most expenditure items do not vary automatically over the cycle, this implies a lower countercyclical impact.

These features, in the abstract, could seem to suggest that the EU-10 need less scope for the play of automatic stabilizers than the former EU-15. Such a conclusion needs to be heavily qualified in three respects. It leaves out of account the possibility that fluctuations in output, the second ingredient of the budgetary safety margin, may be wider in the EU-10. The features of the economy that drive fiscal elasticity vary quite widely across the group of the EU-10. And, of course, these estimates by definition leave out of account the possible exposure of these economies to specific, non-cyclical demand shocks.

Table IV.10. Average budgetary elasticities and sensitivities in the EU10 and EU15 – Preliminary estimates based on OECD methodology as described in van den Noord (2000)

| | Budgetary elasticities | | | | Budgetary sensitivity | | | |
|-----------------------------------|----------------------------------|-------------------------|--|-------------------------|-----------------------|---|-------------------------------|-------------------------|
| | Output elasticity of total taxes | | Output elasticity of current primary expenditure | | Tax burden | Total current primary expenditure to GDP ratio (2004) | Overall budgetary sensitivity | |
| | OECD ⁽¹⁾ | COM ⁽²⁾ | OECD ⁽¹⁾ | COM ⁽²⁾ | | | OECD ⁽¹⁾ | COM ⁽²⁾ |
| | A | | B | | C | D | A*(C/100)-B(D/100) | |
| Average of EU 10 countries | 0.90 | 0.71 | -0.07 | -0.03 | 34.1 | 36.1 | 0.33 | 0.25 |
| | updated | previous ⁽³⁾ | updated | previous ⁽³⁾ | C | D | updated | previous ⁽³⁾ |
| | A | | B | | C | D | A*(C/100)-B(D/100) | |
| Average of EU 15 countries | 0.94 | 0.84 | -0.30 | -0.14 | 41.9 | 40.8 | 0.50 | 0.41 |

Source: Commission services.

(1) The link between output and tax or expenditure base is set equal to the average of the small EU15 countries (2) The link between output and the tax or expenditure base is set to the average of individual estimates of the EU-10 excluding Malta and Cyprus. (3) Released in 2000.

5.5 Interactions with other policies

The contribution of fiscal policy to preserving stability needs to be evaluated in the context of other policy regimes. Monetary and exchange rate frameworks, in particular, are highly relevant to the way financial stress affects the real economy. They also influence private sector risk behaviour: for example, variability in the exchange rate encourages hedging of currency exposure, thus reducing the potential cost of financial stress in terms of the real economy. Monetary regimes thus affect the risks to output against which fiscal prudence can be seen as a form of insurance.

Monetary regimes, of course, vary markedly across the EU-10, and are set to change as they move at differing speeds toward euro adoption. Three examples help to highlight the risk characteristics of monetary frameworks, and related fiscal challenges:

- Under inflation targeting, monetary policy can help contain credit growth and dampen swings in private sector activity to the extent these are threatening the attainment – or tractability – of inflation over the central bank's time horizon. Financial stresses, meanwhile, typically crystallize in the exchange market. This may

facilitate adjustment in the real economy. But if easy fiscal policy results in high domestic currency interest rates, and if the exchange rate is in practice somewhat rigid, these factors can encourage unhedged borrowing among firms and households, giving rise to potentially serious balance sheet risks. While the stabilizing role of monetary policy can ease the task of fiscal policy, unhedged exposure can increase adjustment costs and the burden on the public finances in a crisis.

- Exchange rate targeting regimes such as ERM II highlight the importance of a sound fiscal policy. They also place special demands on the policy mix to help ensure that the exchange rate for euro adoption reflects economic fundamentals. Tight money and an easy fiscal policy, for example, could result in an overly appreciated exchange rate. Credibility also falls under a market spotlight; and evidence of contagion across some of the EU-10 underscores that this is potentially a matter of common concern. (As under inflation targeting, the extent of the associated risks to output would depend in part on the extent to

which unhedged foreign currency liabilities had built up.)

- Under the euro and wholly credible pegs, there is no latitude to use interest rates to address asymmetric upswings in the domestic economy, or to cushion negative shocks on output. Meanwhile, external adjustment plays out through relative price changes. Thus, problems associated with exchange markets are eliminated, but external adjustment can be a slow process if real sector markets are rigid – increasing some potential challenges for fiscal policy.

Such features of the monetary setting thus affect the challenges facing fiscal policy. And changes in monetary regime over time are also important – including notably the shift toward ERM II and the euro. At a deep level, this transition can be taken to signal a growing maturity in monetary transmission channels and decisive progress in nominal convergence – factors that clearly are favourable to stability. However, reduced degrees of monetary freedom have implications for the challenges to fiscal policy. Fiscal trade-offs may need to pay greater heed to stabilization issues. If fiscal policy is not yet well placed to engineer room for manoeuvre – for example, adequate safety margins in terms of the Maastricht criteria or policy mix requirements – then policy-makers will need to weigh this carefully before shifting to a more constraining monetary regime.

In these respects, it is crucial to distinguish between Treaty requirements and the principles of prudent fiscal management – which will normally take account of financial market risks to the convergence path and the desirability of keeping stabilizers available at all times. It is prudent management that suggests minimizing risks of a last minute market disturbance (for example, following a shock to the public finances) during the approach to euro adoption; and also that adequate room for stabilizers within the SGP limits be built in at the time when Member States become members of the euro area. These considerations may imply a more ambitious consolidation path in the approach to ERM II and euro adoption than implied by a mechanical observance of the Maastricht reference value.

In addition to monetary policy regimes, the goals of supervisory policies in the financial sector, which address the health of institutions, are supportive of financial stability. Prudential frameworks can contribute particularly where supervisors internalize systemic risks in evaluating institutions' credit and market exposures. Concerns about stability during convergence arise in part from capital market imperfections and risk assessment problems (for example, under-pricing indirect exposure to currency risks, or the perception of implicit guarantees on funding). Several supervisory approaches – such as stress-tests – can reduce risks; and so can close and active co-operation between home and

host supervisors of systemically important foreign establishments.

Finally, it is important to bear in mind the influence on financial stability of governance standards and of real sector frameworks. Regarding the former, a range of official policies and private codes of conduct relating to governance in the non-financial sector affect the efficient and stable functioning of non-financial corporations. This is a question that deserves heightened attention in light of structural shifts underway in the distribution of risk in the economy: there is a tendency in all economies for financial institutions to lay off on clients financial risks that formerly they themselves bore. Regarding flexible real sector markets, these are clearly crucial in reducing the potential costs to growth when the economy needs to adjust to real or financial shocks. They are thus a key element influencing the extent of output risks against which prudent fiscal policy is a form of insurance.

5.6 Risks, safety margins and fiscal institutions

A number of factors differentiate the EU-10 from other EU Member States. Most obvious, on the favourable side, is the potential for higher output growth, which will enhance debt-carrying capacity; and the fact that, in some cases, these Member States enjoy a much lower initial public debt ratio. On the more cautionary side there may be continuing risks of economic and financial volatility affecting debt dynamics and output stability, especially in those cases where structural transformations and financial catching-up are still underway.

There is also a risk, during rapid convergence, of over-estimating potential growth and, particularly, the durability of revenues associated with credit and asset price booms. This latter factor is especially relevant to the EU-10 that are likely to experience a very rapid growth in credit toward equilibrium levels over the next few years. These are arguments not for a more restrictive policy during convergence, but for a stance that takes underlying developments and their variability correctly into account.

There are, by contrast, two factors that could argue – on grounds of prudent fiscal management and market signals in some specific situations – for a fiscal stance more restrictive than those implied by the Maastricht fiscal criterion or by medium-term SGP goals. These are, first, the possibility that sizable current account deficits could trigger, in the future, a rise in risk premia that threaten capital market access; and second, the need to pay close regard to issues of credibility, safety margins, and policy mix in the run-up to euro adoption.

There are drawbacks in discretionary adjustments to fiscal policy to respond to such market risks at the time they emerge. In particular, ad hoc cuts in spending may

fall heavily on investment, and time-lags mean that the withdrawal may be mistimed. The uncertainties and costs of discretionary action underscore the case for prudent medium-term goals; but they also prompt the question what are complementary routes to help preserve stability. One obvious option is to exploit the stabilizing role of strong fiscal institutions.

In this respect, a key challenge for fiscal authorities in the EU-10 is to establish credibility in sticking with budgetary plans and fulfilling commitments. A common source of slippage is the failure of spending ministers and local authorities to internalize the social costs of their demands, the so-called ‘common pool problem’. Fiscal institutions can be designed in ways that help limit this source of expenditure bias (see section 2.3 in part II of this Report). One such approach is to delegate formation, monitoring and implementation of the budget to a single policy body – for instance, a finance minister with a leading role in the budgetary process (the ‘delegation approach’). Fragmentation of the process can also be limited by increased co-ordination among spending ministers and levels of government, possibly through formalised rules and procedures (the ‘commitment approach’). Most EU-10 seem to have embarked on reforms in their fiscal institutions in line with this approach (Ylaoutinen (2004)).

Most EU-10, in recent years, also introduced multi-year budgetary frameworks to better internalize the medium-term consequences of decisions on spending programmes in the formation of the budget and to improve ex-post monitoring. Many had already moved to better integrate the activities of extra-budgetary funds in the budget process and to increase the co-ordination of spending decisions across levels of government (Gleich (2003), Ylaoutinen (2004)).

In spite of this progress, there is still room to strengthen fiscal governance in the new Member States. First, the introduction of agreed provisions how to use better-than-expected budgetary outcomes in ‘good times’ will be helpful to avoid loosening the stance of fiscal policy during periods of strong growth. Second, future reforms could contribute to reduce the high share of so-called ‘mandatory expenditures’ in some EU-10, i.e., those that to be changed require additional legislation on top of the budget law, thus improving the ability of budgets to react to shocks. Third, strengthened practices in evaluating expenditure (e.g., via cost-benefit analysis techniques in project selection, periodic reviews of programmes, establishment of output-oriented indicators of government actions) could contribute to increase the effectiveness of government expenditure and achieve cost savings.

In addition to strengthening institutions, a further approach may help improve potential trade-offs for fiscal policy: microeconomic aspects of policy that influence economic stability. A key priority in this regard is to avoid creating distortions that could amplify

boom-bust cycles in the private sector (such as untargeted mortgage subsidy programmes, and interest rate deductibility schemes).

Such institutional and microeconomic priorities need to be pursued over a medium-term time horizon. Nonetheless, they can offer important routes to strengthen the stabilizing quality of fiscal policy for any given level of deficit and public debt. They thus can improve importantly the potential trade-offs or complementarities between stability and growth that face policy-makers during the convergence process.

5.7 Fiscal challenges and country situations

When assessing trade-offs or complementarities, a final key consideration is the wide variety of economic and fiscal circumstances in the EU-10:

- A number of the EU-10 in central Europe face significant challenges in keeping public debt ratios within prudent bounds. In these economies too, it is plausible that the elasticity of fiscal balances to output is close to that in the former EU-15, albeit perhaps somewhat less. Larger fiscal deficits in some cases also pose policy co-ordination challenges that could affect the exchange market. Output costs of exchange rate variability have proved a concern. Seen from a stability perspective, these factors suggest significant challenges ahead in ensuring that fiscal policy contributes fully to economic stability. On the other hand, these economies may also have greater scope for a restructuring of existing expenditure programmes that is itself growth enhancing. Recent reforms in Slovakia (Box IV.6) illustrate the scope for enhancing both growth and consolidation.
- Stability risks show a different profile in the Baltic states. Deficit and debt levels are on average far lower. The scope required for automatic stabilizers may be less, and the stabilizing impact of fiscal policy is limited by the size of the public sector. Current constraints on policy result mainly from the need to underpin the credibility of currency board-style exchange regimes; to provide assurance to financial markets that wide external current account deficits do not have their source in any misallocation in the public sector; and to avoid fiscal amplification of trends toward real appreciation.
- In the two island economies, debt and deficit challenges are coupled with the need to ensure the market credibility of their exchange rate pegs. These economies, like those in central Europe, appear to have significant scope for

expenditure reforms in achieving consolidation. A factor that differentiates them from the other EU-10 is that their financial sectors are already much more fully developed: potential risks that could arise from rapid credit growth are less relevant for them.

The challenges for fiscal policy over the next few years will not be static. As the EU-10, at different times in the future, enter ERM II and adopt the euro, the evolving monetary setting will modify fiscal challenges. Six of the EU-10 now participate in ERM II, but these do not include the four larger EU-10 in central Europe which currently have flexible exchange rates. For those four countries, policy mix and credibility risks may come more strongly to the fore in the run-up to the euro. This could occur in an environment of rising levels of euro-denominated liabilities, and hence of balance sheet risks. Moreover, contagion within the group could be an issue. Once they have adopted the euro, some of these economies may still face challenges to ensure scope for automatic stabilizers and to keep the public debt on a credibly sustainable path.

In the Baltic states, by contrast, stability concerns may ease somewhat after euro adoption: the issue of hard-peg credibility will disappear, and debt and automatic

stabilizer profiles will remain undemanding. The potential challenge will lie more in the issue how policy should respond to the scale and composition of private sector imbalances. A key will be to ensure that potential growth and revenue performance are assessed prudently. The outlook for public debt and potential growth may allow somewhat less constrained fiscal balance positions within the framework of the reformed SGP. However, in the process of transition it would be crucial to avoid a fiscal stimulus at cyclically inappropriate times.

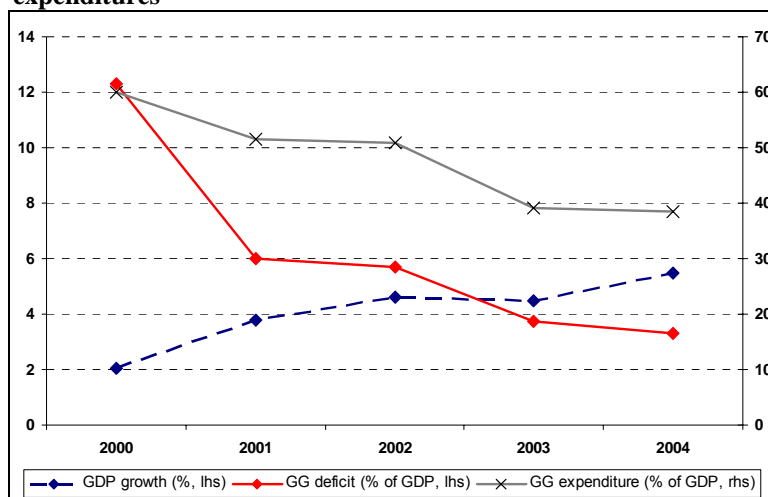
A stylized analysis along these lines is thus somewhat encouraging from a policy perspective. Taking into account the differing profiles of the EU-10, it is plausible that complementarities exist, even in the short run, between growth-enhancing tax and expenditure reforms and decisive progress with consolidation where this is needed.

If such a conclusion were borne out by in-depth country assessments, it would be very important: there is no escaping the urgency, particularly in certain cases in central Europe, of improving substantially both the prospects for growth and the outlook for the fiscal balance. The convergence programmes prepared by the EU-10 offer a vehicle to explore these issues, including dimensions that are matters of common concern.

Box IV.6. Slovakia: fiscal reforms, strong growth, and a declining deficit

Slovakia illustrates the feasibility of far-reaching public finance reforms, combining growth orientation with fiscal consolidation. Since end-2002, it has implemented a comprehensive tax reform package and a broad array of structural expenditure reforms, while strengthening fiscal institutions. The fiscal deficit and the expenditure ratio fell substantially (to 3.3% of GDP and 38.5% of GDP in 2004, respectively), while growth accelerated (to 5½% in 2004). A strong flow of (greenfield) FDI bodes well for future growth performance. This should facilitate further fiscal consolidation, in combination with a reorientation of expenditure towards Lisbon goals. Achievement of the Maastricht deficit reference value in 2007 is within reach.

Graph IV.17. GDP growth and general government deficit and expenditures



Source: Commission services.

On the revenue side, the tax reform package led to a considerable shift from direct to indirect taxation, simplified the system and increased transparency, strengthening incentives and enhancing growth. Based on preliminary estimates, the reform package appears to have been broadly revenue-neutral. Key elements were: the introduction of a flat tax rate of 19% for both individual and corporate income taxation, coupled with the removal of tax exemptions; introduction of a unified VAT tax rate of 19%; increases of several excise taxes; and abolition of some less significant taxes (inheritance tax, gift tax) and amendments to some other smaller taxes (real estate tax, vehicle tax). In addition, health and social insurance contribution rates for employers and

employees have been reduced, albeit to a still relatively high total level of some 48% of gross wages.

On the expenditure side, reforms focused in particular on the targeting and incentive aspects of social transfers – improving the growth-enhancing quality and the sustainability of the public finances. Key measures were: (1) Reform of pensions: changes in key parameters of the pay-as-you-go pillar (benefit formula with closer link between contribution history and pension claims; stepwise increase of the retirement age; indexation based more on inflation); and introduction of a sizeable funded pension pillar (diversion of contributions of 9% of gross wages to that pillar). (2) Other changes to social insurance (e.g. unemployment and sickness benefits), benefits (e.g. child benefits), and assistance, emphasising targeting and incentives. (3) Changes to healthcare systems (e.g. introduction of co-payments; introduction of individual private health insurance; streamlining of the health benefit package; better incentives and harder budget constraints for health care providers).

On the institutional side, as part of a comprehensive public finance management reform project supported by the World Bank, Slovakia has improved all steps of the budget cycle. In particular, the medium-term orientation has been strengthened and, together with the budget 2005, a detailed multi-annual budget framework for the years 2005 to 2007 was elaborated. The obligation to submit annual convergence programmes in the context of EU surveillance procedures acted as additional catalyst for reforms.

