Editorial: Public Finances in Eastern Europe

The recent turmoil in European highlighted how sensitive international investors have become with respect to the sustainability of public finances. Also the exchange rates and government bond yields of the countries in Central and Eastern Europe (CEE) got temporarily under pressure again. These economies were affected by the global crisis in different ways, depending on the room of manoeuvre for fiscal and other economic policies in carrying out anti-cyclical measures. Despite a slowdown of economic growth and mixed forecasts concerning future trends in Eastern Europe, this country group has managed to cope with the consequences of the global recession much better than expected. However, there are wide differences in the performances of individual countries, but a financial collapse of the state could be avoided in all cases.

After a drop of 3.6% of GDP last year recent growth forecasts reckon with a moderate upturn of 1.6% or perhaps even more for this year and about 3% for 2011, indicating that the stabilisation process seems to be successful.

Nevertheless, private consumption, income, output and investment shrank more or less everywhere, especially in the Baltic States, in Hungary and in Romania. In other Central-European countries the drop of consumption turned out to be moderate, and in the case of Poland – the only East-European country with a positive GDP growth rate for 2009 – private consumption even expanded. In this latter group output in the sectors construction, market and public services could partially offset the impact of the severe shrinking of output in manufacturing. After a pronounced disinflation could be observed in most countries of the region in 2009 – with the exception of Hungary, Romania and Poland - with the pickup of economic activity inflationary pressure will grow again sooner or later all over the region, but should remain under control.

Ample liquidity, easing risk aversion, combined with returning confidence in financial and capital markets will have positive impacts on financial trends in the Eastern European countries. Reference yields on state bonds with longer maturities as well as CDS spreads normalised, and prime rates could be adjusted downwards even in those countries with higher risk ratings. However, this optimism may be clouded by the recent financial turmoil and the still unforeseeable consequences of the Greek crisis.

After the group of CEE countries had recorded a general budget deficit of just about 1% of GDP in 2007, it rose to 5.8% by 2009. The deterioration of the general government balance was worst in the Baltic States, where only Estonia managed with drastic cuts in budget expenditures to stabilise the deficit ratio at about 2% of GDP. At the same time Latvia and Lithuania – despite cutting pensions and public wages substantially – could not avoid a rise of the general government deficit to as much as 9% of GDP. However, with the help of a nominal decrease of wages and incomes they managed to avoid a default which can be considered as a success.

Hungary and Romania were two other countries showing a relatively high volatility of public finances. However, in 2009 both countries managed to take austerity measures aiming at a consolidation of the state budget and helping to regain confidence of financial markets. Fiscal policy efforts proved to be successful in Bulgaria where the deficit remained at a relatively low level of 3.9% in relation to GDP in 2009, while the slowdown of economic growth remained also within a moderate range especially as compared to the Baltic States or Romania.

Although the fiscal situation deteriorated substantially in the two Euro area members of Eastern Europe, i.e. Slovenia and Slovakia, their reputation is much better than that of many other countries of the region that are not in the Euro area, and despite a severe drop of investment activity, private consumption remained relatively stable and the first signs of a recovery could be observed already during the last months of 2009.

Summing up, the Eastern European countries show a rather heterogeneous picture regarding their public finances. There are countries with low deficit and debt ratios like Bulgaria or Estonia. In other countries both the debt level and the budget balance showed a sudden rise, while still remaining under control (like the Czech Republic, Slovakia or Slovenia). In some countries, governments were forced to implement severe austerity measures which will bring perceptible results only if economic growth gains momentum (like Hungary or Romania), or countries which hardly avoided the threat of a total financial collapse (like Latvia or Lithuania). In some CEE countries, in addition to the indebtedness of the state budgets the indebtedness of private households may cause severe tensions as well.

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Leaders & laggards, on the way down and up

The crisis hit hardest in more open economies...

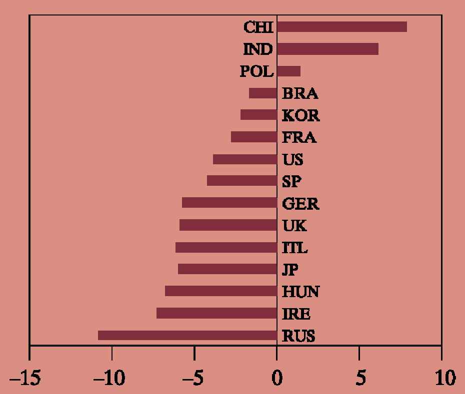
With the global economic recovery now on a firmer footing, it is a good time to analyse some of the main features of the crisis and assess what the upturn may look like. Although it was expected that economies which were most dependent on financial services, where consumers were particularly indebted, and where house prices were most overvalued, would suffer the most, the outcome proved to be rather different.

The downturn surprised in terms of the rapidity and intensity with which it spread throughout the world. The devastating collapse in world trade was linked partly to a sharp reduction in trade credit and partly to a more integrated global supply chain, which meant that demand shocks would feed more swiftly across countries.

As graph 1 demonstrates, the largest falls in real GDP in the year to 2009Q2 were concentrated amongst countries which were most exposed to the global economy. This exposure covered a number of channels including trade, especially in capital goods (Japan and Germany), capital flows (Hungary, Russia) and commodity prices (Russia). A savage destocking cycle contributed to the very sharp declines in real GDP in the more open economies.

Graph 1

Change in real GDP
2009 Q2 against 200 Q2, in %



Source: Oxford Economics.

...but longest recessions mainly confined to economies where excesses were larges

Still, prior expectations regarding the relative impacts of the crisis were partly borne out by events in 2009H2. In Europe, those countries where excesses during the pre-crisis period had been of a more egregious nature (UK, Spain, Ireland), have endured more protracted recessions. The UK eventually returned to growth in Q4 but this was two quarters later than Japan, France and Germany; whilst Spain and Ireland have continued to contract and are not expected to return to growth until later in 2010.

In part, this reflects the need for greater structural rebalancing in these economies.

In the UK it is hoped that the fall in sterling will facilitate an export-led recovery, relieving the pressure on highly indebted consumers and a public sector which is about to enter a lengthy period of fiscal retrenchment. However, net trade continued to act as a drag on growth in Q4 suggesting that this process has not yet begun. In Spain and Ireland significant restructuring away from still-bloated construction sectors will be required to generate sustained growth.

Meanwhile, growth in Germany and Japan has been able to slip more easily back into its pre-crisis pattern, with both countries' manufacturing sectors benefiting significantly from the rebound in global trade. In the case of Japan, the economy has particularly benefited from the surge in Chinese import demand associated with the government's fiscal stimulus package and loosening of lending conditions.

The important exception to this picture is the US, which despite exhibiting some of the worst excesses in the run-up to the crisis, rebounded relatively strongly from 2009Q2, albeit that much of the growth was attributable to a temporary boost from the reduction in the pace of destocking. Private consumption began to gather momentum over the past six months, despite fears that the sharp deterioration in labour market conditions and an extended period of consumer deleveraging would constrain consumer spending growth. Indeed, our baseline scenario is that despite a relatively modest rise in the savings ratio, private sector deleveraging is largely complete, although signs of a rebound in net trade, required to correct problems of "global imbalance", are less clear.

What will the medium-term recovery look like?

Recent data releases have painted a relatively positive picture for the global economy. PMI surveys from the UK and core Euro area countries have typically been on an upward curve, whilst the ISM composite index continues to rebound strongly in the US. Therefore, we are relatively bullish over prospects for 2010Q2, although clearly the fallout from continued problems from the Greek fiscal crisis presents downside risks. Although we feel that the risks of a "V-shaped" recovery have risen in recent weeks, our baseline scenario remains for a medium-term recovery that is both bumpy and sluggish by historical standards.

There are a number of factors behind this. Firstly, it has become somewhat of a stylized fact that recoveries in the wake of a financial crisis tend to be more protracted, as a hobbled banking sector holds back the real economy. Secondly, we feel that the repair of household and corporate balance sheets is likely to be a drawn-out process.

We estimate that the loss of household wealth, due to sharp declines in house and share prices, amounted to around 90% of GDP in the US, UK and Spain, with lower but still considerable falls in France and Italy. Even with very bullish assumptions over asset price growth, it would take years for wealth to return to its pre-crisis level, implying that consumers are likely to be more cautious, particularly given still high levels of personal indebtedness. Furthermore, the global economy remains characterised by high levels of excess capacity due to the scale of the recent recession in many countries. This implies that scope for investment will remain limited for some time to come. Finally, the impetus from fiscal policy is set to fade considerably from 2011 onwards, partly in response to mounting pressure for government retrenchment. Together with monetary tightening, the policy environment is clearly set to become less supportive to growth.

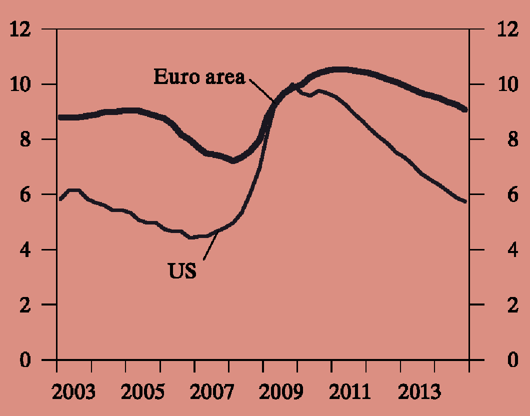
And how much divergence between countries can we expect?

The OEF forecasts imply that the US is likely to be the growth leader of the recovery phase, reflecting the more dynamic nature of its economy and financial sector.

The rebound in Europe is likely to be more sluggish, reflecting lower rates of potential growth while we also expect to see increased levels of divergence between the

Graph 2

Unemployment: US versus Euro area 2003 – 2014, in %



Source: Oxford Economics, Haver Analytics.

"core" and "peripheral" members of the Euro area.

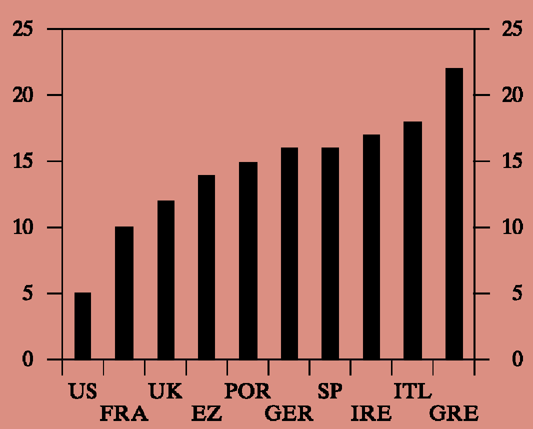
One key difference between the US and Europe will be a much more robust medium-term labour recovery in the former. Despite the sharp rise in long-term unemployment and the need for a certain degree of structural rebalancing, we would suggest that concerns over a "jobless" recovery in the US are largely unwarranted. Implied labour productivity surged in the wake of the global financial crisis as unemployment leapt sharply, with employers possibly anticipating a more severe downturn. This suggests that there may be a significant level of pent-up demand, which would translate into solid job growth, should expectations of a sustained recovery become entrenched. Graph 2 illustrates both the much sharper rise in US joblessness during the crisis and also our forecast for a speedier medium-term recovery in job creation.

Another factor that will be crucial to the recovery pattern will be the health of the banking system. This is particularly true in the Euro area, where bank lending accounts for more than half of the total financing to the non-financial corporate sector, in contrast to the US where the corporate bond market is currently a more important source of financing. Moreover, the most recent IMF estimates suggest that US banks are at a more advanced stage in writing off bad debt than their European counterparts. Meanwhile, in the UK the 2010Q1 Bank of England Credit Conditions Survey pointed to continued improvement in the supply of credit to both households and businesses, although demand remained relatively weak. In summary, UK and US banks appear to be at a comparatively more advanced stage of absorbing credit-related losses and rebuilding capital ratios than their Euro area peers.

A third area that will critically affect the dynamics of the recovery will be the performance of the residential real estate market, both in terms of its effect on household wealth and bank balance sheets. The most dramatic decline in house prices has been in the US and most metrics suggest that prices are now close to fair value. However, demand has been propped up by government interventions such as the homebuyer tax credit. This expired at the end of April suggesting that the current rebound may lose steam in the near term. In the UK, prices have staged a recent recovery, although this has been driven by a lack of supply with home-owners reluctant to concede a loss on their purchase. Therefore, we feel that there is a high probability of a "double-dip" and forecast a further decline in 2010H2, with the market failing to gather much momentum before 2012/13. In contrast, most Euro area economies (Spain and Ireland being the obvious exceptions) were not characterised by the same level of short-term excess in the run-up to the crisis.

Graph 3

Number of quarters for GDP to return to pre-crisis level



Source: Oxford Economics.

Overall, we expect the recovery to be stronger in the US, as reflected in graph 3, which shows the US returning to its pre-crisis peak level of GDP much faster than the UK and the Euro area economies. The chart also highlights the growth-retarding impact of structural rebalancing, with the slowest recoveries concentrated among the Euro area peripheral nations.

What will be the key legacies of this crisis?

A recession on the scale of that recently experienced will leave scars on the global economy for years to come. Possibly the most important, and certainly one which has been under sharp focus in recent weeks given events in Greece, are the very large fiscal deficits accumulated by most major economies and the accompanying sharp rises in sovereign debt. At the very least, this will constrain growth going forward as governments are forced to engage in substantial retrenchment. More immediately, the risk of a full-blown sovereign debt crisis continues to rise despite the recent Greek bail-out package. The current market reaction suggests that serious concerns remain about the possibility of default, an event that would almost certainly trigger widespread contagion in both the Euro area periphery and parts of Eastern Europe.

A second potential legacy relates to the regulation of the financial services sector. Little of any consequence has been agreed at the international level although some principles for regulatory reform, such as counter-cyclical capital ratios, are now widely shared. Overall, we feel that large-scale reform is unlikely given the difficulties presented by generating a cross-country consensus and the lobbying power of the financial sector. Much will depend on the speed with which changes can be implemented, as impetus for reform will wane the further the crisis becomes removed from recent memory.

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New Papers from EUREN-Institutes

RWI/IHS

Practice and Prospects of Medium-term Economic Forecasting

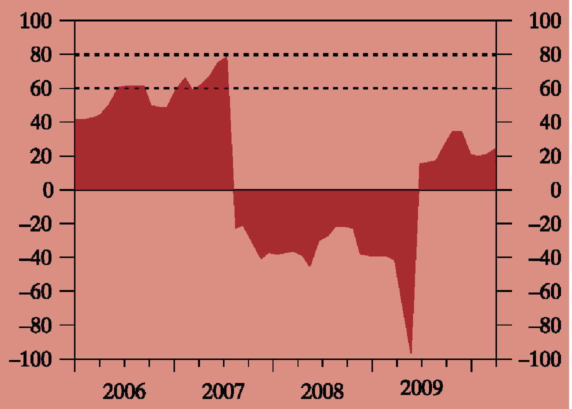
by Helmut Hofer, Torsten Schmidt and Klaus Weyerstrass

Government agencies and other national and international institutions are asked to perform forecasts over the medium term. In particular, the EU Stability and Growth Pact contains the obligation to formulate stability programmes over four years, covering a general economic outlook as well as the projected development of public finances. However, the current practice of performing medium-term economic projections is unsatisfactory from a methodological point of view as the applied methodology has been developed for short-run forecasting and it is questionable whether these methods are useful for the medium term. In particular, currently medium-term projections are mostly based on the neoclassical Solow growth model with an aggregate production function with labour, capital, and exogenous technological progress. It might be argued, however, that for medium-run projections endogenous growth models might be better suited. In this paper we give an overview of currently used methods for medium-term macroeconomic projections. Then we analyse the performance of medium-term forecasts for Austria to illustrate the strengths and weaknesses of the typical approach. In particular, the five-year projections of real GDP growth, inflation and the unemployment rate are investigated. Finally, we describe some approaches to improve medium-run projections.

Ruhr Economic Papers #177 (http://www.rwi-essen.de/rep)

Coe-Rexecode Leading Indicator for the Euro Area

Despite a very disappointing zero-growth in the last quarter of 2009, we still continue assuming that the euro area GDP shifted in the third quarter of 2009 to the ascendant phase of the growth cycle. This means growth over the trend growth rate estimated now at 1% on an annual rate. This is in line with our underlying growth rate estimated at 2.6% in March 2010 and most other composite indicators available on the market (Eurocoin, OECD leading indicator, Eurostat-OFCE and Conference Board indicators). The Coe-Rexecode leading indicator is now looking for the next peak. It must overpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent economic reversal of the present rebound. A too quick signal would mean an abortion of the present cyclical upturn. It is far to be the case. In March, the indicator stands at 24.6, far below the first 60 threshold. The Coe-Rexecode Start-End recession index is delivering a similar message. It converged towards zero in February 2010, meaning a zero probability to be in recession. The last indicator to quit the recession zone was the unemployment rate which is close to stabilize.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: April 28, 2010

	09Q1	09Q2	09Q3	09Q4	2009	10Q1	10Q2	10Q3	10Q4	2010
Jan-09	–1.8 ; *–0.4*	–2.0 ; *-0.4*			–2.0					
Feb-09	–2.4 ; *–0.8*	–2.7 ; *-0.5*	–2.9 ; *–0.4*	–2.7 ; *–0.5*	–2.7					
Mar-09	–2.7 ; *–0.8*	–3.5 ; *–1.1*	–3.6 ; *–0.3*	–2.6 ; *–0.5*	–3.1					
Apr-09	**[–2.7 ; *–0.7*]**	–3.2 ; *–0.8*	–3.1 ; *–0.1*	–2.0 ; *–0.4*	–2.7					–0.9
May-09	**[–3.8 ; *–1.7*]**	–3.0 ; *0.6*	–2.5 ; *0.3*	–1.2 ; *–0.4*	–2.6					–0.5
Jun-09	**[–4.7 ; *–2.6*]**	–3.9 ; *0.6*	–2.9 ; *0.8*	–1.0 ; *0.3*	–3.1					0.5
Jul-09		–3.7 ; *0.8*	–2.3 ; *1.2*	–0.2 ; *0.5*	–2.7					1.1
Sep-09	**[–4.9 ; *–2.6*]**	**[–4.7;*0.8*]**	–3.1 ; *1.3*	–0.7 ; *0.7*	–3.3					1.1
Oct-09			–3.2 ; *1.2*	–0.7 ; *0.8*	–3.3					1.4
Nov-09			–3.3 ; *1.1*	–0.7 ; *0.8*	–3.4					1.4
Dec-09	**[–5.0 ; *–2.4*]**	**[–4.8 ; *–0.2*]**	**[–4.1 ; *0.4*]**	–1.6 ; *0.6*	–3.9	0.9 ; *0.0*	1.2 ; *0.2*			1.4
Jan-10	**[–5.0 ; *–2.5*]**	**[–4.8 ; *–0.1*]**	**[–4.0 ; *0.4*]**	–2.1 ; *0.0*	–4.0	0.4 ; *0.0*	0.8 ; *0.3*			0.8
Feb-10	**[–5.0 ; *–2.5*]**	**[–4.8 ; *–0.1*]**	**[–4.0 ; *0.4*]**	**[–2.1 ; *0.1*]**	–4.0	–0.2 ; *–0.5*	–0.3 ; *–0.5*			0.5
Mar-10	**[–5.0 ; *–2.5*]**	**[–4.8 ; *–0.1*]**	**[–4.0 ; *0.4*]**	**[–2.1 ; *0.1*]**	**[–4.0]**	–0.1 ; *–0.5*	0.2 ; *0.2*	0.9 ; *1.1*	0.7 ; *–0.1*	0.4
Apr-10	**[–5.0 ; *–2.5*]**	**[–4.8 ; *–0.1*]**	**[–4.0 ; *0.4*]**	**[–2.1 ; *0.1*]**	**[–4.0]**	0.0 ; *–0.4*	0.2 ; *0.1*	0.1 ; *0.3*	0.0 ; *0.0*	0.1

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.
During the first two months of the year, incoming data led to a sharp downward revision of the prospects for the first half of 2010. However, more recent data made the outlook somewhat brighter. Nevertheless, the trend forecasted for the end of this year remains very weak. The latest estimates for the second half of 2010 are even lower than the previous ones.

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Impressum
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