

Fiscal crisis?

in Europe and Central Asia
A Stock-Taking Exercise

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“If I were reborn, I would like to be reincarnated as the Bond
Market”
(James Carville, former advisor to President Clinton)

Main points

1. Before the crisis, deficits and debt were falling across the region. Fiscal policies improved on many fronts;
2. But in the latter half of the decade, pre-crisis, buoyant revenues led to less fiscal restraint and a postponement of some needed reforms;
3. During the crisis, fiscal policy responses differed in the east and west
 - Reliance on automatic stabilizers in most countries
 - Fiscal stimulus programs in resource-rich economies.
4. After the crisis, fiscal adjustment priorities will be even more differentiated
 - Education and infrastructure needs high in much of region
 - Social insurance expenditure too high in Central and Southern Europe
 - Increasing efficiency, for example by reducing energy subsidies in middle-income Former Soviet Union
 - Withdrawing stimulus
 - Revisiting tax policy?

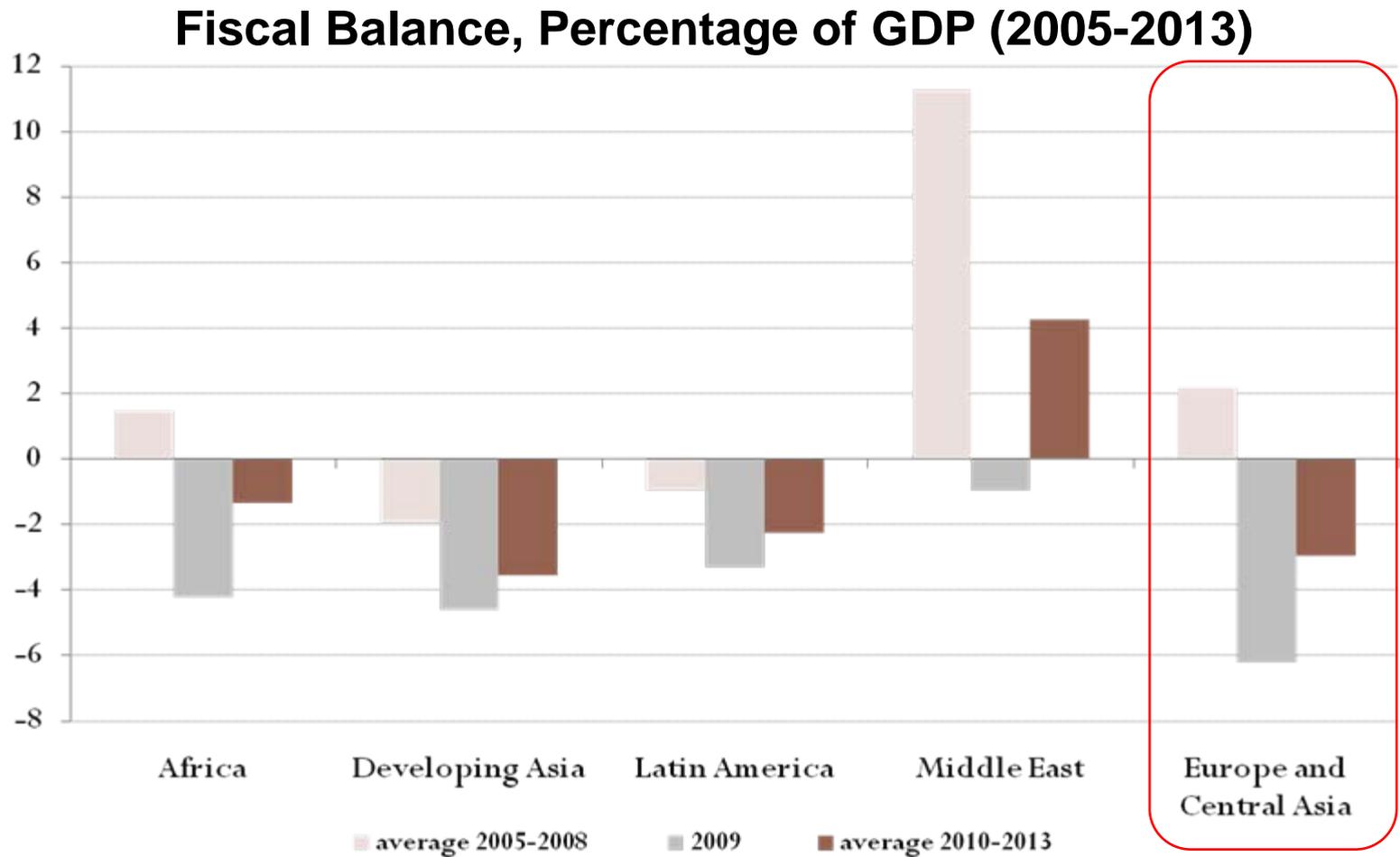
Outline

- Backdrop to fiscal focus
- 1. Before the crisis
- 2. During the crisis
- 3. After the crisis
- 4. Fiscal consolidation

Backdrop

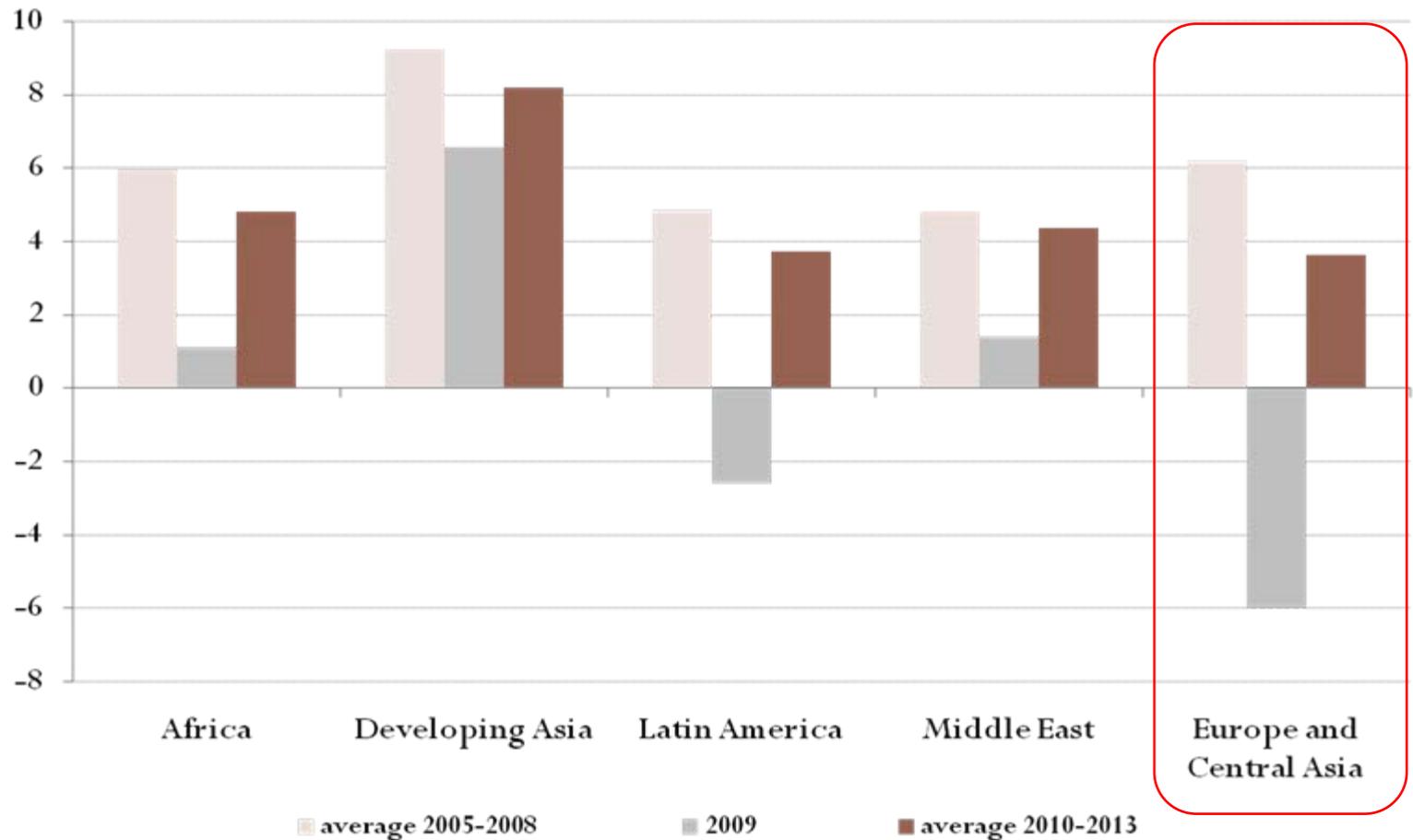
- **Emerging Europe and Central Asia hit harder than other developing regions by global crisis**
- **Southern Eurozone countries hit hard**
- **Growth and fiscal prospects for the region are bleaker than for others**
- **The region also has a daunting climate action agenda particularly for EU accession countries**

Worst fiscal performance among regions



Weakest growth prospects

Real GDP Growth, Annual percentage rate (2005-2013)

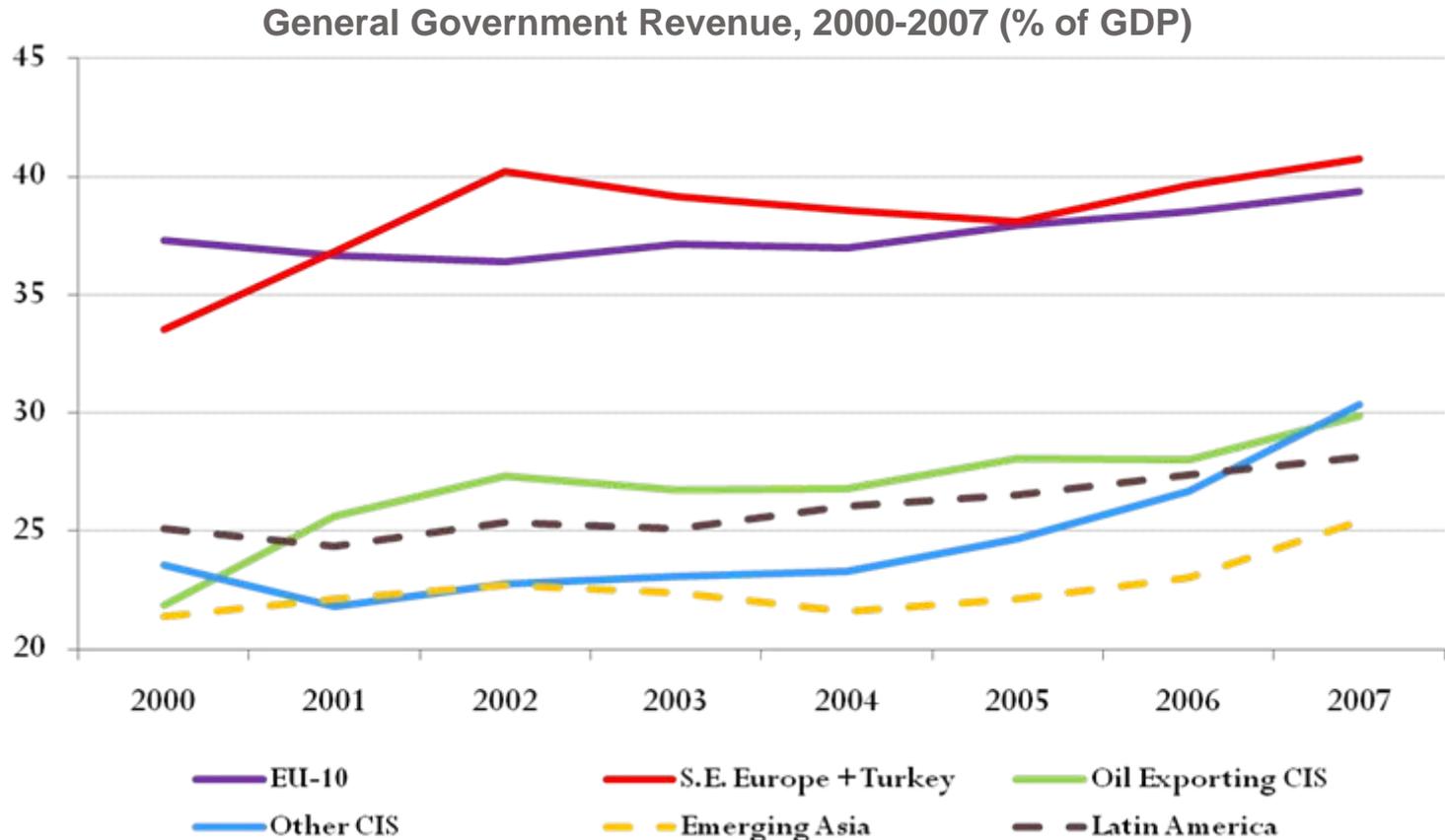


Before the crisis

- **Revenues rose rapidly as trade and consumption based tax collections increased**
- **Spending rose almost as fast in aggregate, but steady as share of GDP**
- **Fiscal balances improved across the region, with a few exceptions (Hungary and Georgia)**
- **But budgeting and spending efficiency did not improve as much**

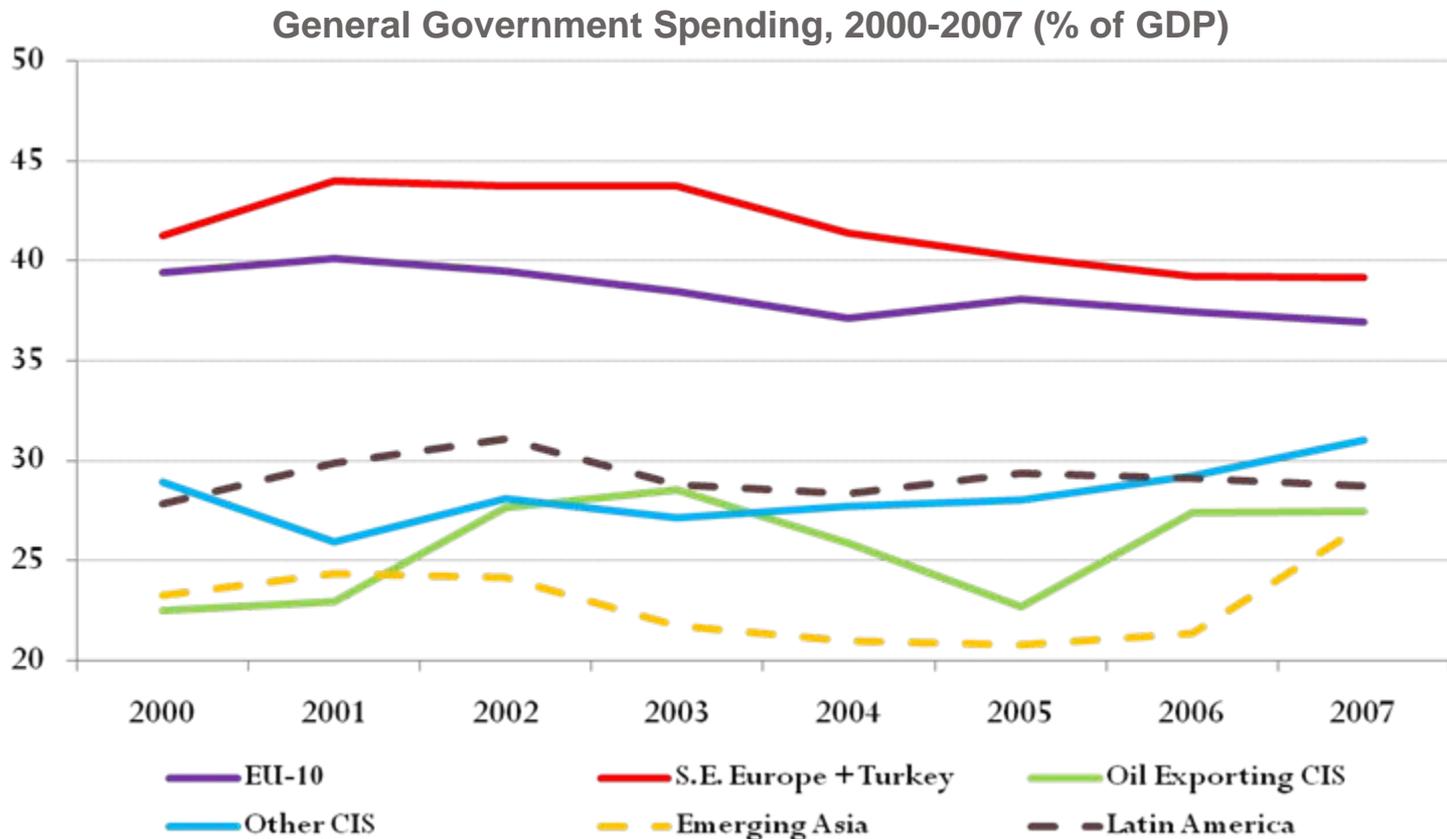
Revenues rose

Steady increase as share of GDP, but aggregate increased from \$700bn in 2000 to \$1.2 trillion in 2007



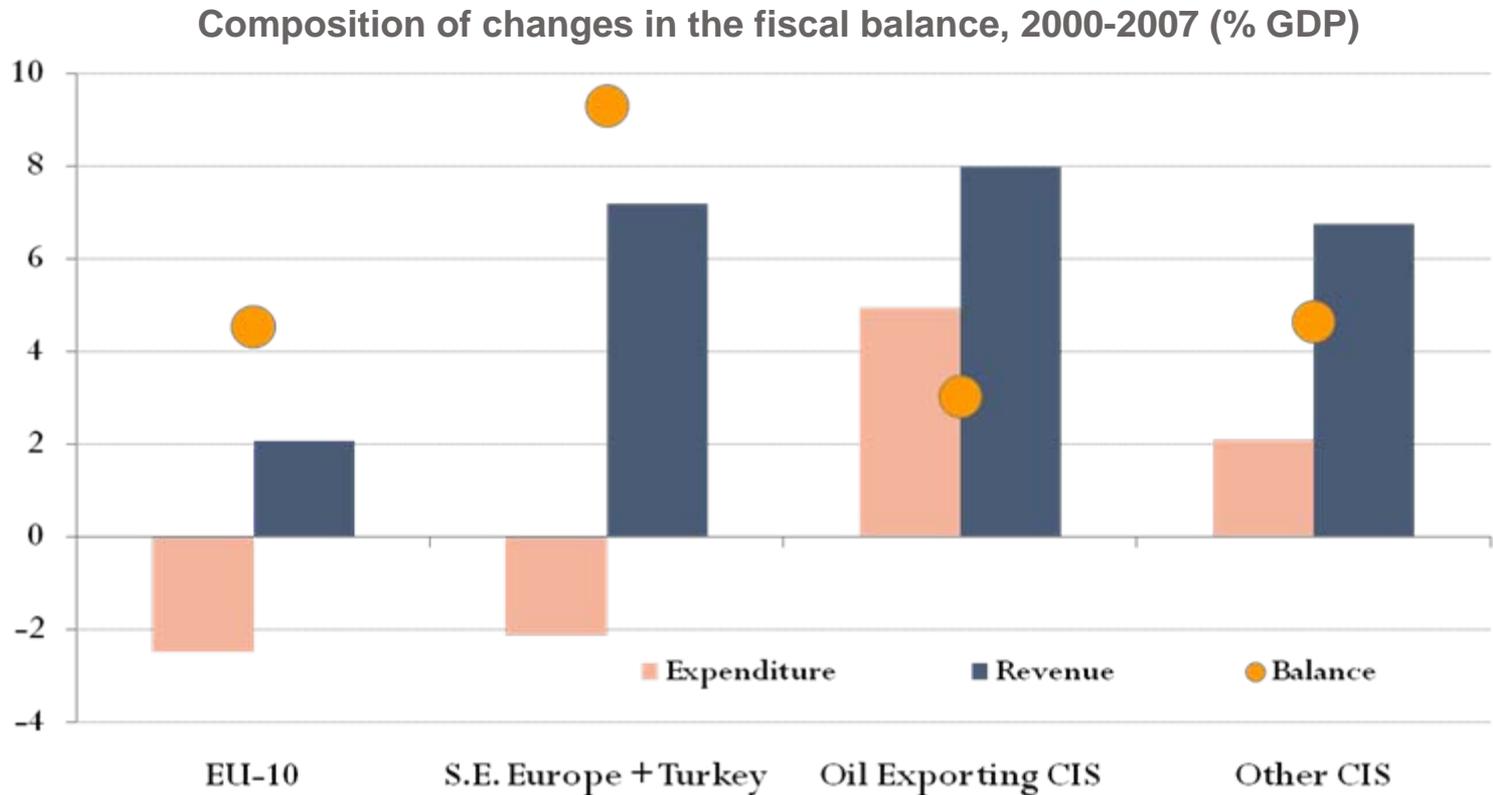
Spending up almost as much

Steady as a share of GDP, but rose in aggregate from \$700 billion to \$1.1 trillion



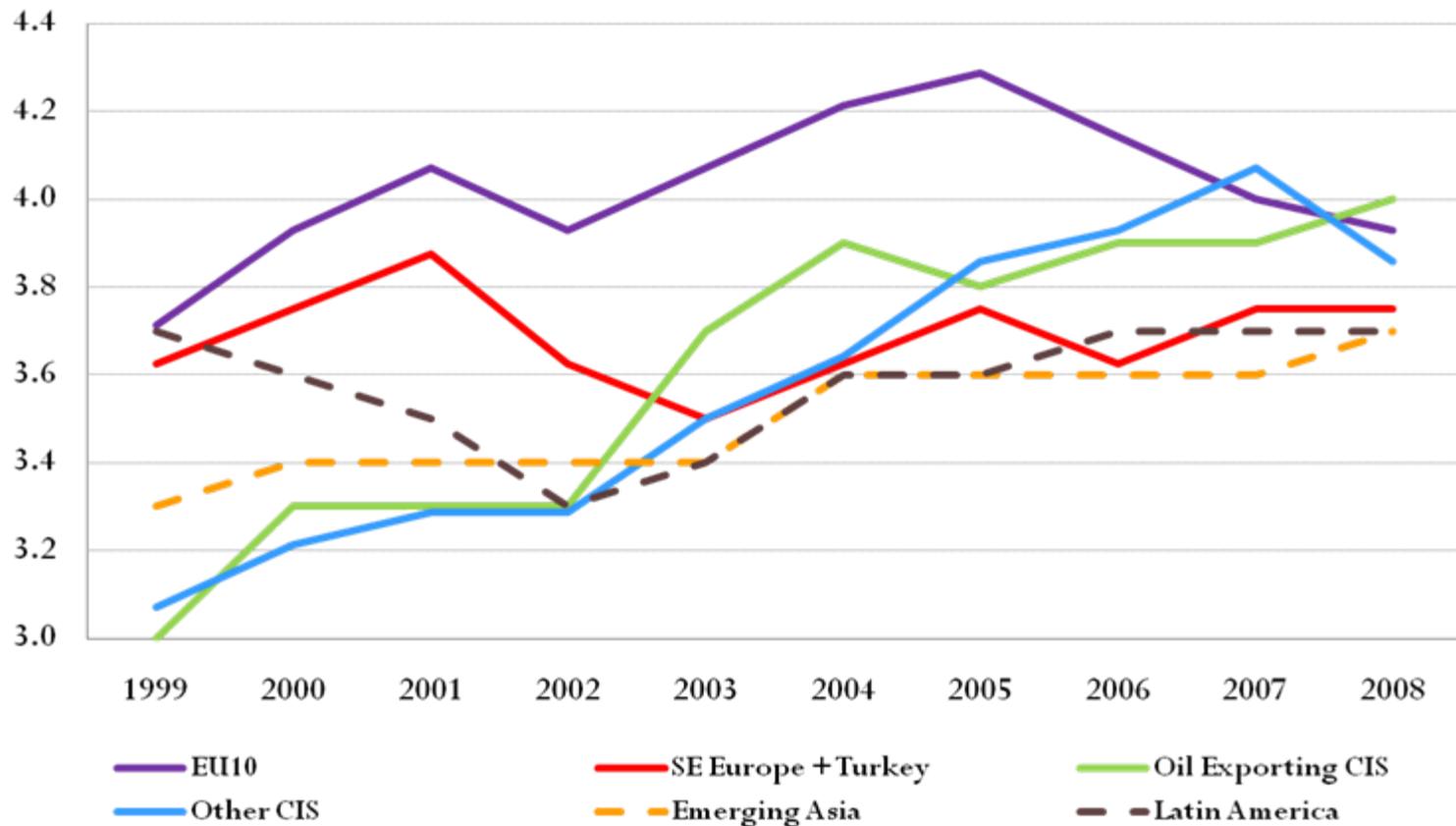
Fiscal balances got better

Spending increased in east, more controlled in the west



Fiscal policies improved

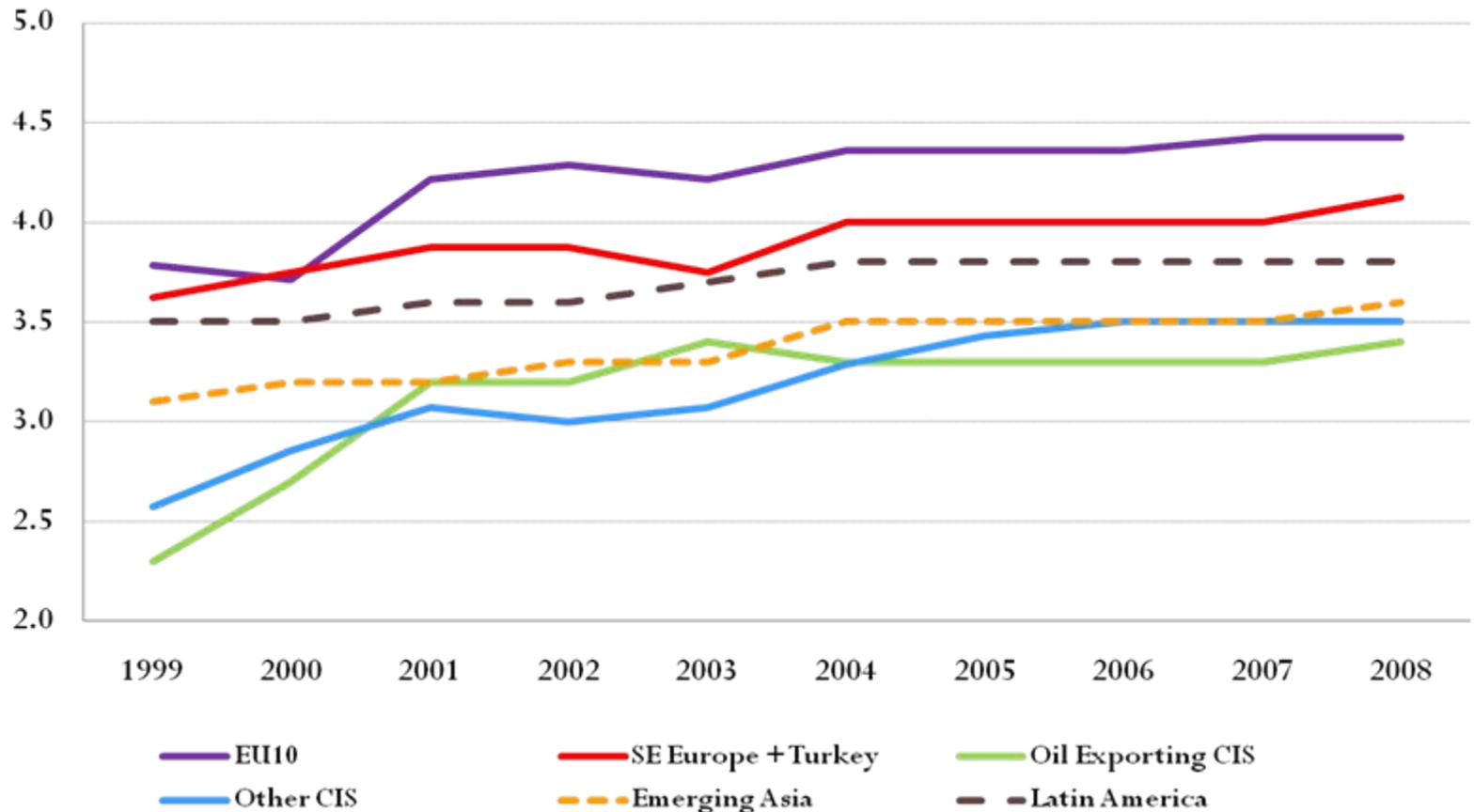
Outside the EU-10, the quality of fiscal policy improved



Source: World Bank Country Policy and Institutional Assessments; measure of the Quality of Fiscal Policy, 1999-2008

Revenue efficiency improved

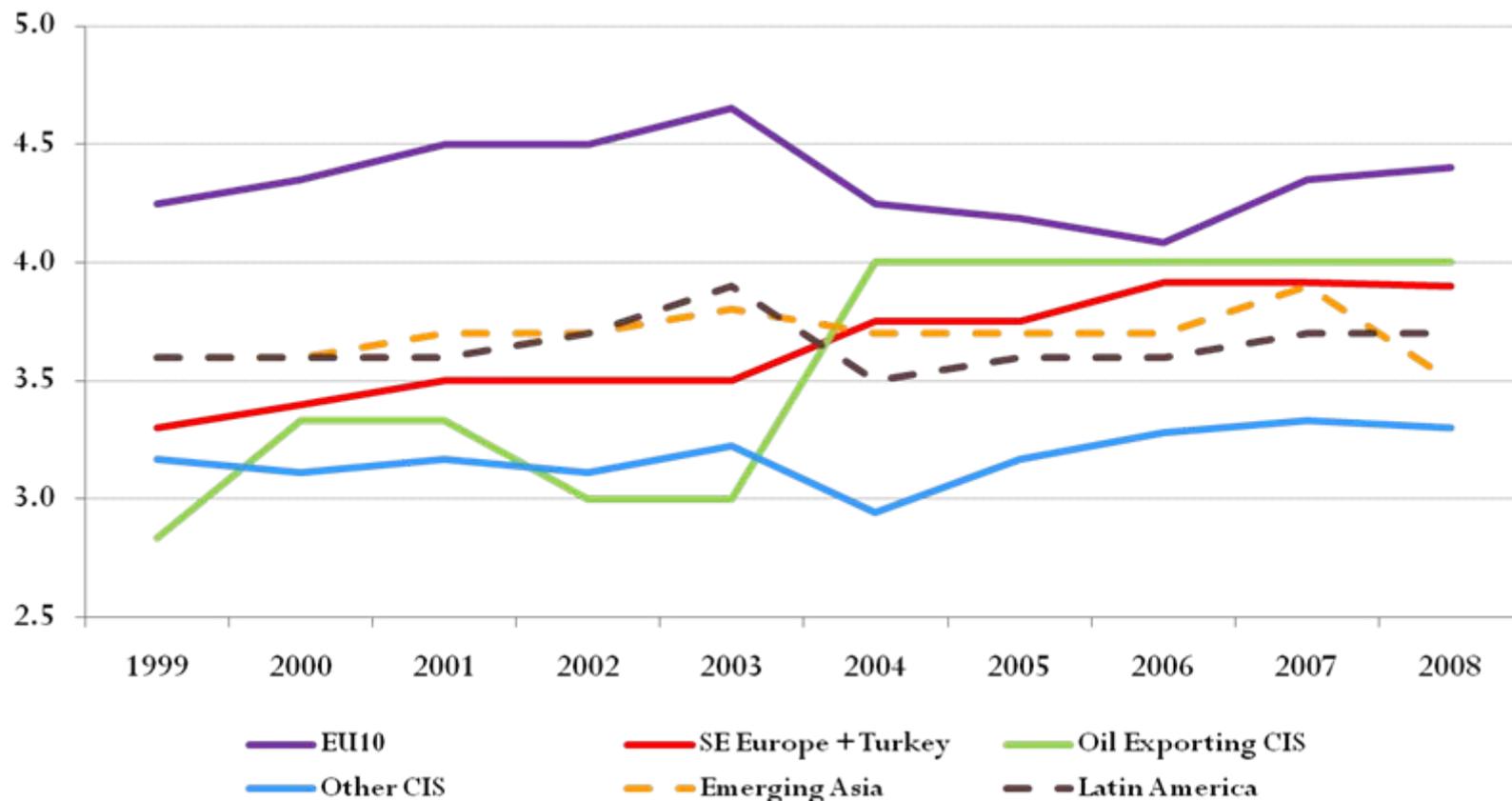
Efficiency of revenue mobilization increased



Source: World Bank Country Policy and Institutional Assessments; measure of the Efficiency of Revenue Mobilization, 1999-2008

Some managed budgets a bit better but uneven performance

Public financial and budget management improved less



Source: World Bank Country Policy and Institutional Assessments; measure of the Quality of Budgetary and Financial Management, 1999-2008

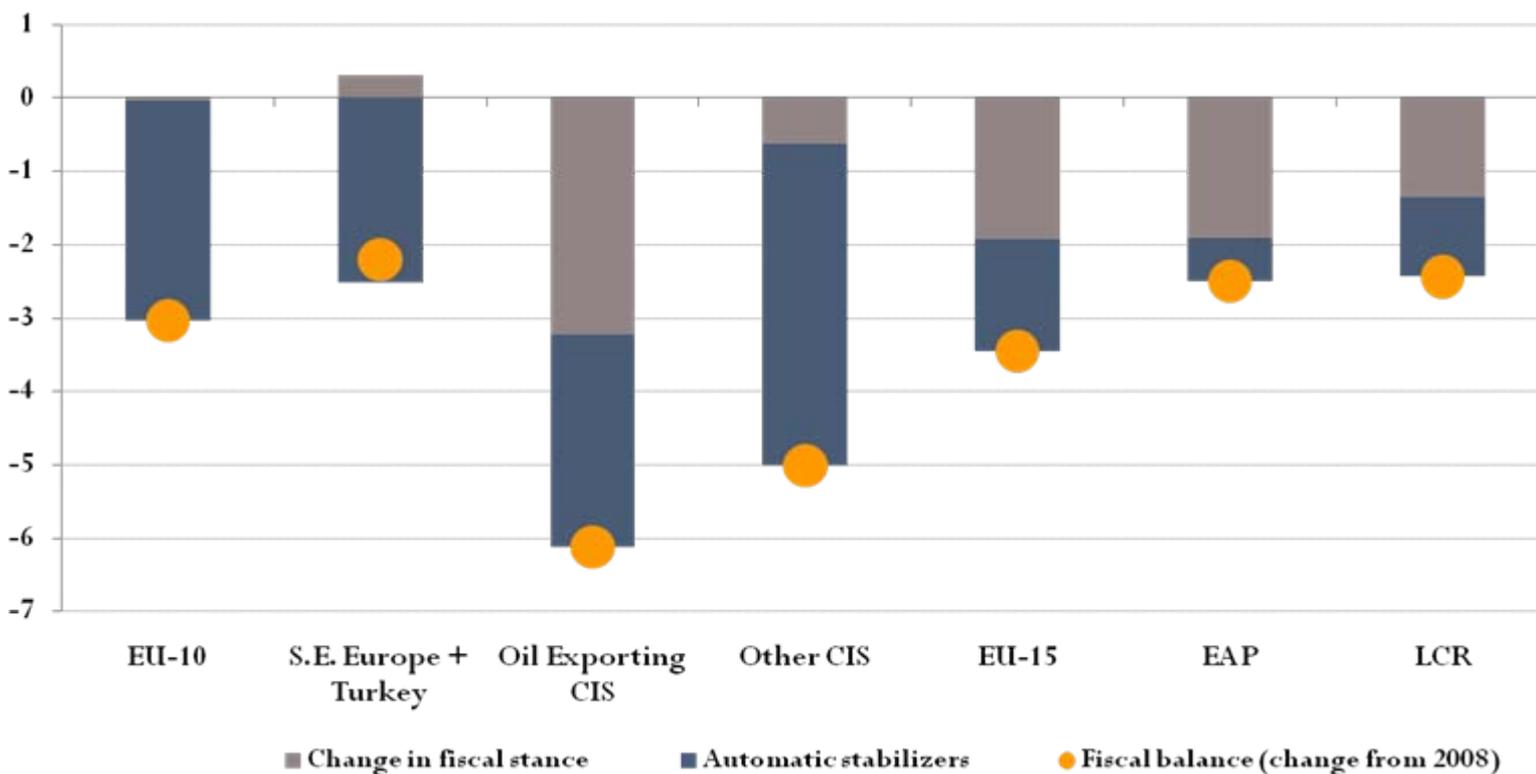
During the Crisis

- **Government revenues fell everywhere, but more in the east**
- **Public spending rose as a share of GDP, but stable in aggregate**
- **Fiscal balances deteriorated everywhere, but more in the east**
- **Oil and gas exporters implemented fiscal stimulus programs, but exit unclear**

All relied on automatic stabilizers

Only ECA's oil exporters implemented discretionary fiscal stimulus programs

Contributions of changes in deficits, 2008-2009, % of GDP, median values



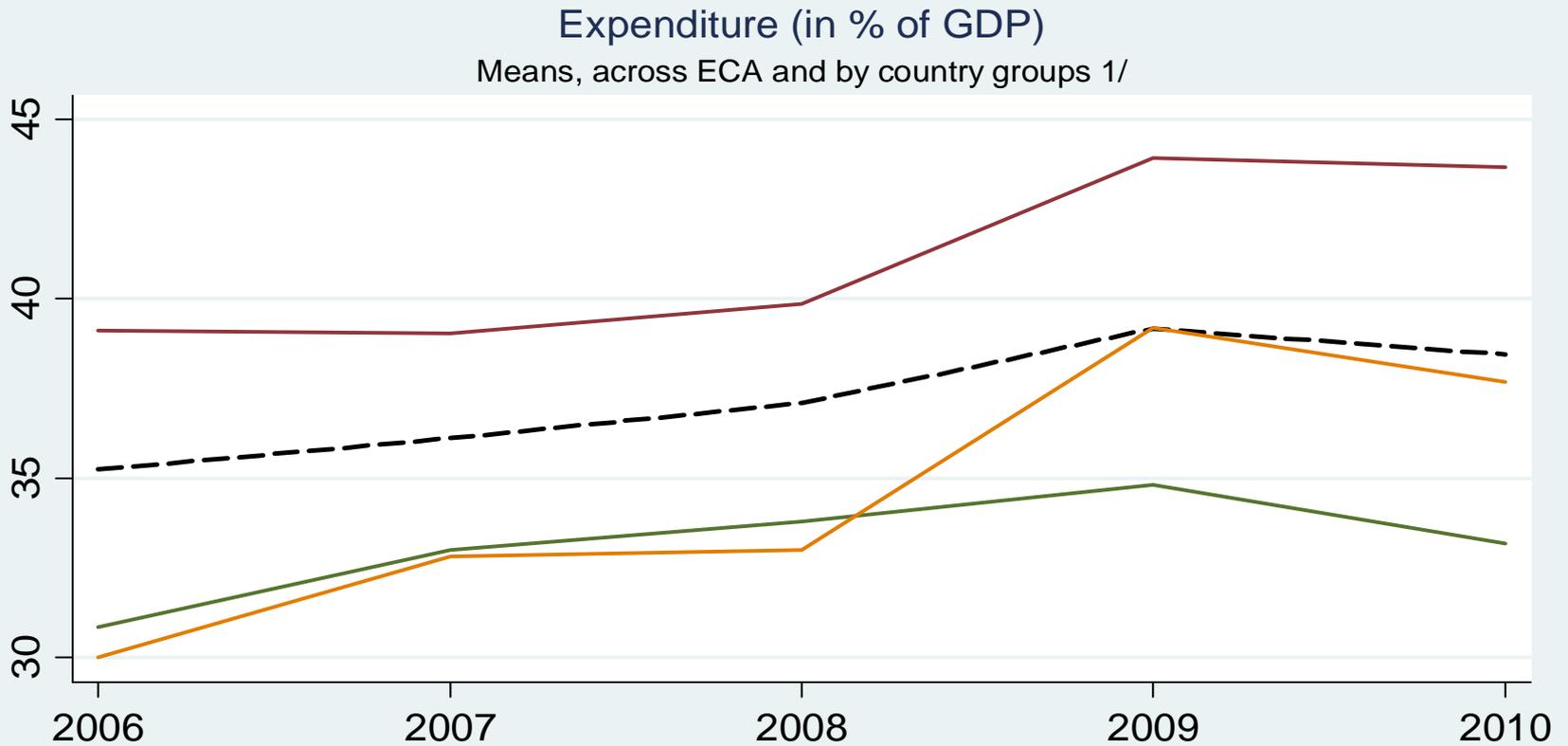
The crash of 2008/09: Macroeconomic developments affected the fiscal situation via different channels

- Countries where the financial sector was hard hit experienced immediate strain on the Treasury and GDP growth (Latvia, Hungary, Russia)
- Oil exporters were hard hit by the decline in world oil prices and the change in demand (Russia, KZ, Azerbaijan, Turkmenistan). Fiscal revenues: e.g. export taxes took a big hit
- Very open countries (such as the EU10+) suffered from the dramatic decline in trade and this affected revenues linked to GDP and trade
- Remittances fell leading to a large decline in consumption (e.g. Moldova) and related tax revenues

The crash of 08/09: on the public expenditure side

- Automatic stabilizers, where in existence, went to work
- Rigidities or unwise policy choices came back to haunt some countries: Romania, Ukraine, Serbia, Latvia, Hungary (wages and salaries or pensions/pension indexation).
- Countries, fearing rising debt levels (or a negative impact on the exchange rate) had to adjust expenditure plans downwards and expenditure allocations within the budget. Capital expenditures an easy target
- A few countries raised expenditures or held them constant in nominal terms: Kazakhstan, Russia, Georgia, Bulgaria, Moldova
- Few countries had nominal declines: Latvia (09), Croatia (09), Hungary (09)

Public Expenditure (in % of GDP)



--- ECA Wide

— EU10+Croatia+Turkey

— LLMIC (less AZE and TKM)

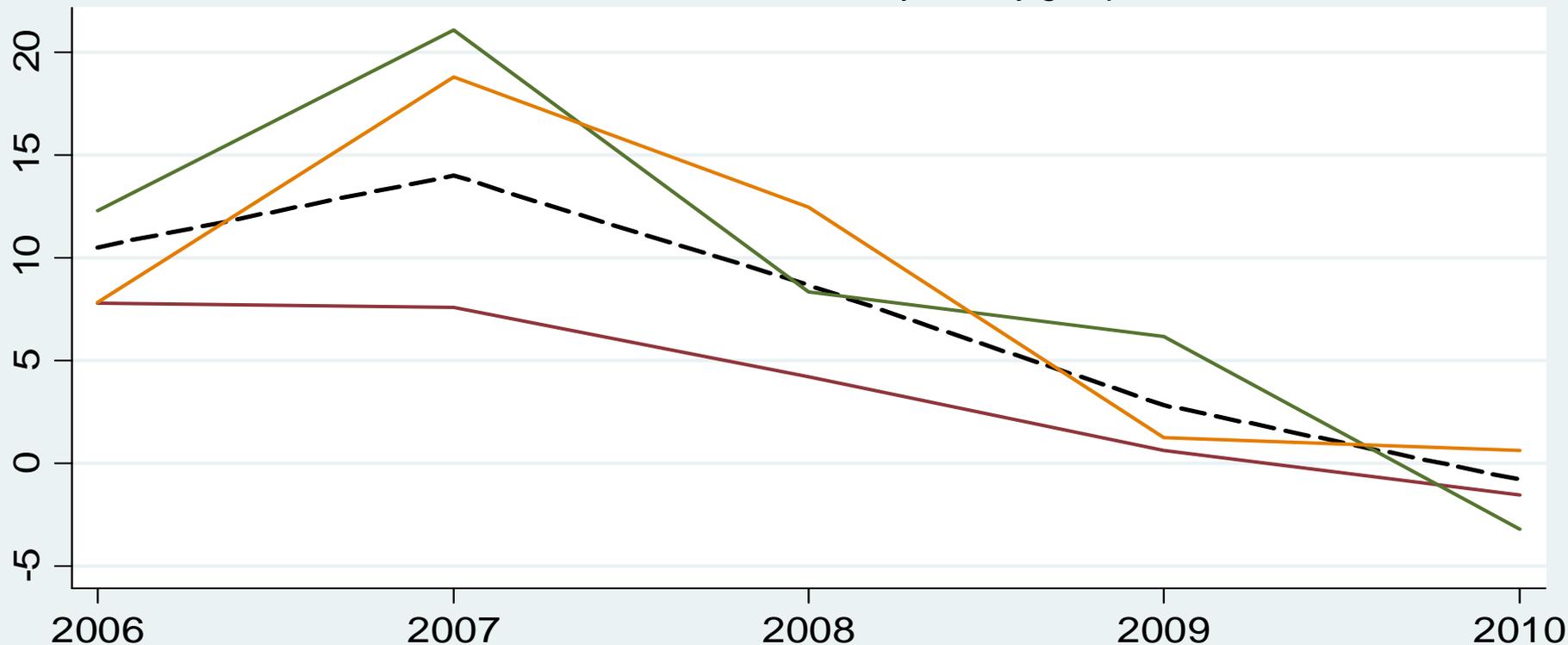
— Oil & Gas Exporting Countries (weighted mean)

Data source: ECA Regional Tables

1/ Oil Exporting mean does not include Turkmenistan prior to 2004

Public Expenditures, Real growth

Expenditure Growth, y-o-y, real
Means, across all ECA and by country groups



--- ECA Wide

— LLMIC (less AZE and TKM)

— EU10+Croatia+Turkey

— Oil & Gas Exporters Group (weighted mean)

Data source: WEO

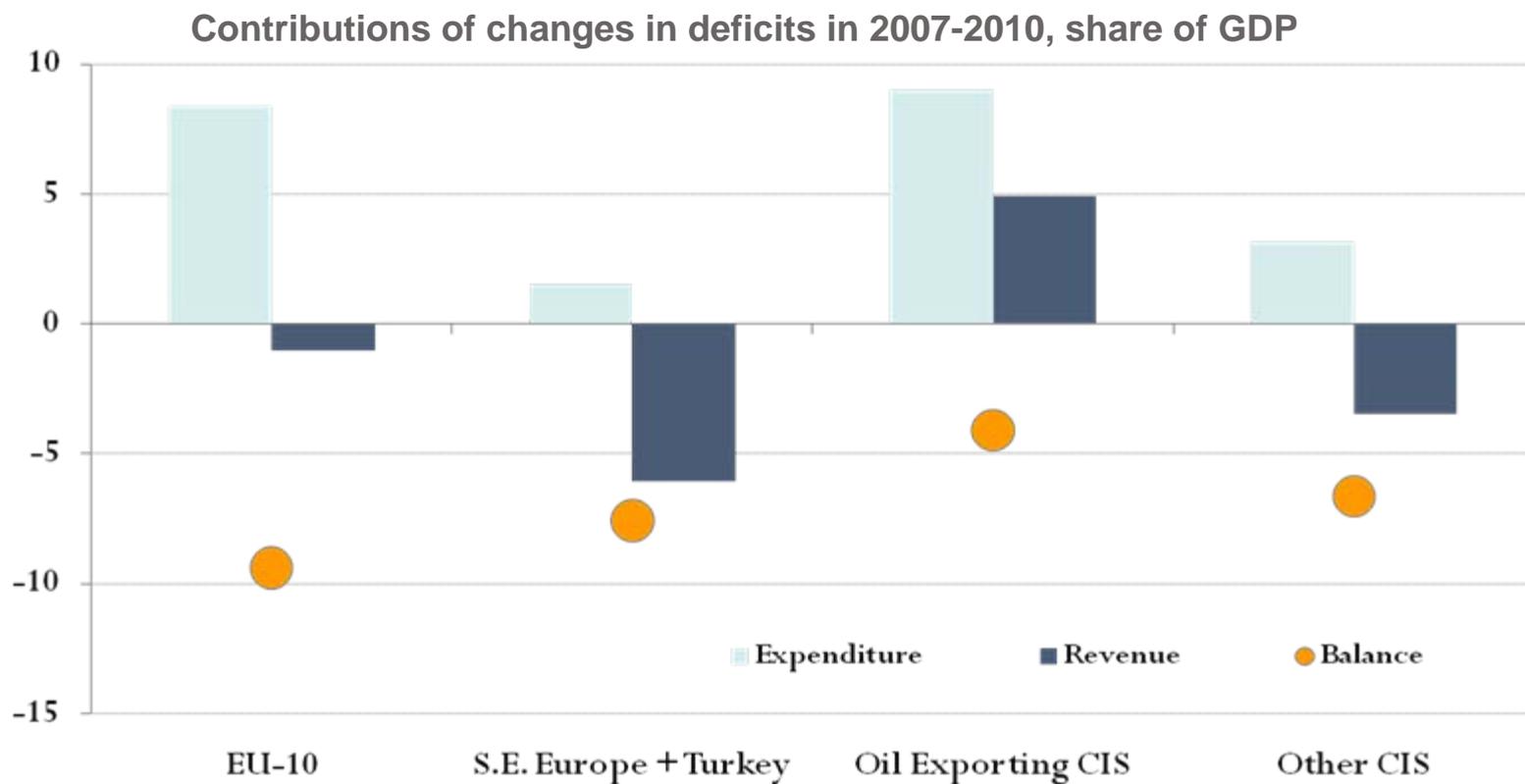
Discretionary spending varied

Tax relief, financial sector support and expanded unemployment insurance benefits most common

	Wage Bill Constraints	Public Works	Increased Social Transfers	Expansion of Unemployment Benefits	Limits on Pensions	Financial Sector Support	Investment Expenditure Cuts	Tax Reductions
Belarus	X						X	X
Croatia							X	
Czech Rep				X	X	X		X
Estonia			X		X			
Kazakhstan		X		X		X		
Poland			X	X		X		X
Russia		X			X	X		X
Slovenia				X				X
Turkey	X	X		X		X		X
Ukraine						X	X	

Big fiscal imbalances emerged

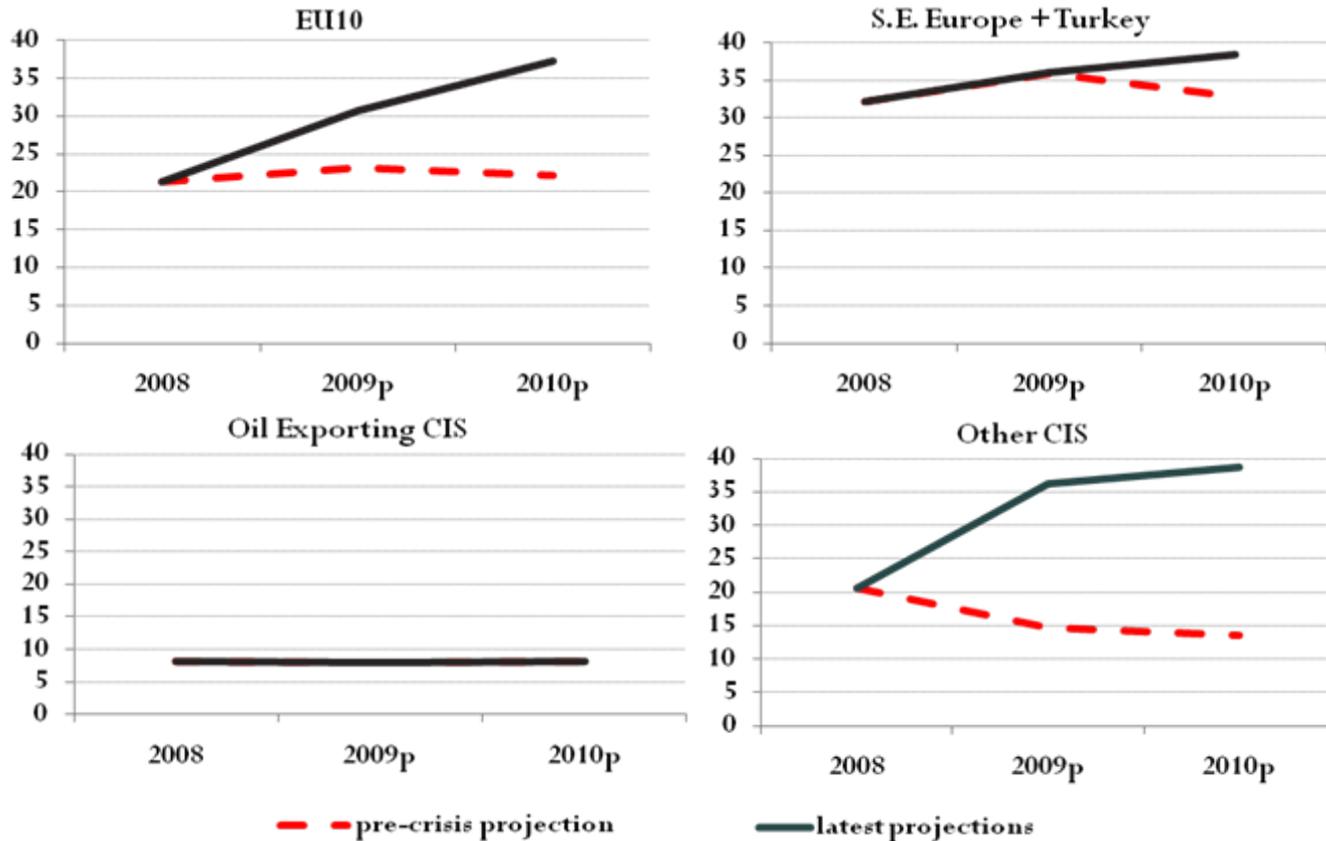
**Expenditures responsible for rising deficits everywhere;
big revenue declines in SE Europe and parts of the CIS**



And public debt has grown

Public debt in Central and Southern Europe, and the non-oil rich CIS will be close to 40 percent in 2010

Projected public debt, % of GDP



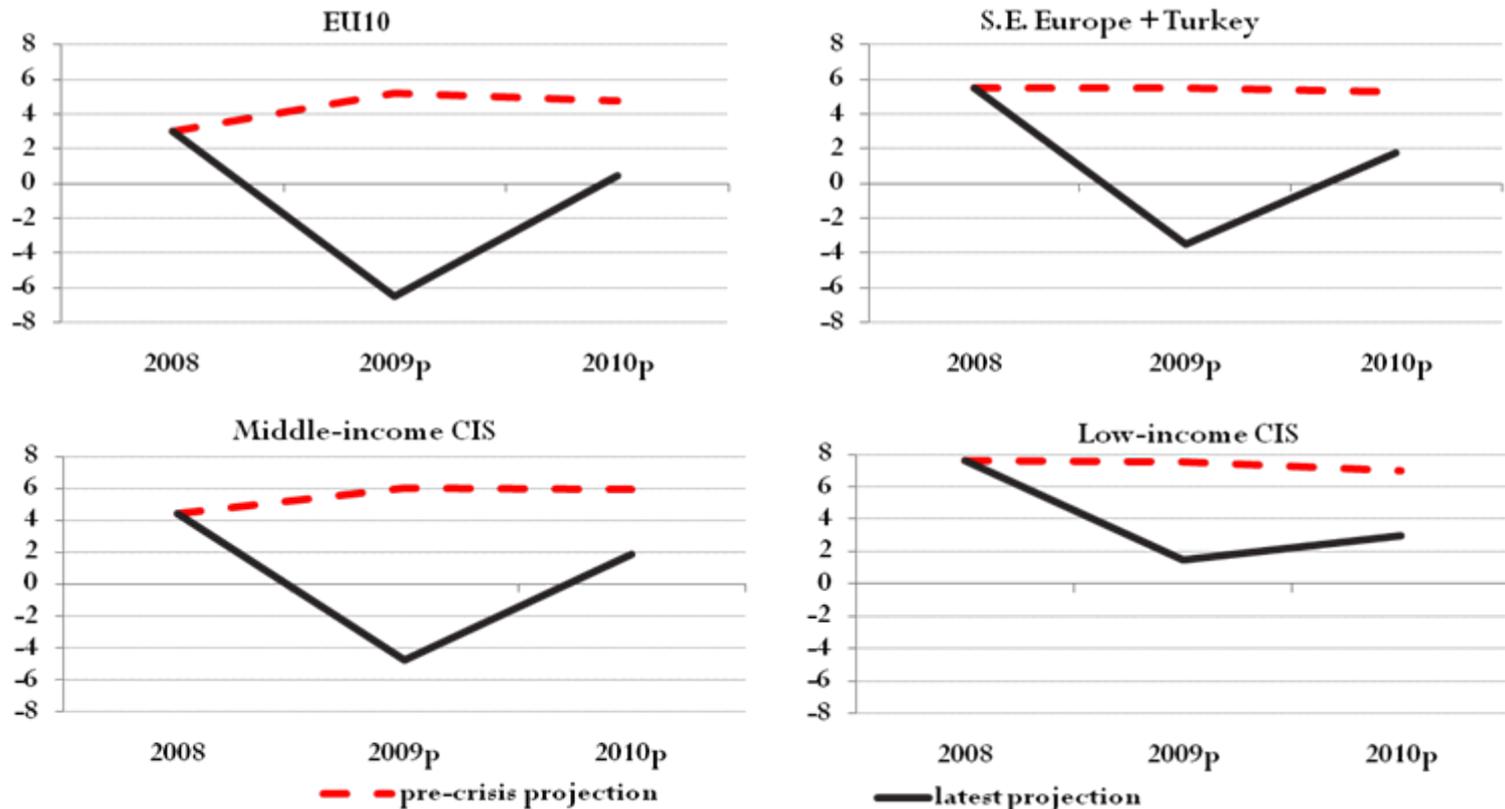
After the crisis

- **Growth projected not to recover to pre-crisis levels**
- **Pressures to increase spending**
- **Projected divergence in spending and revenue trends within the region**

Lower growth post-crisis

GDP growth in 2010 will be about 5 percentage points lower than what was expected before the crisis

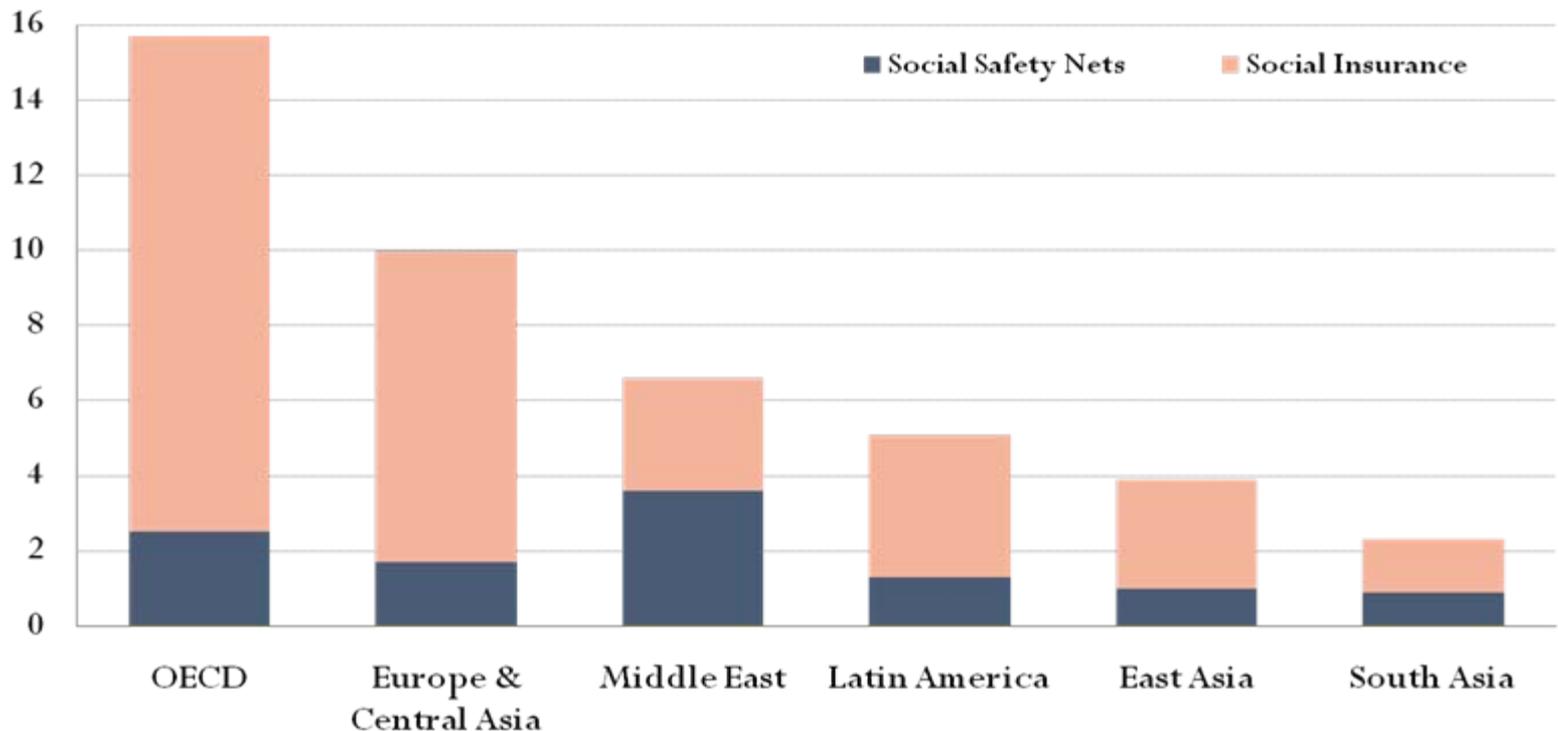
Projected economic growth rates, before and after crisis



More pressure to reform pensions

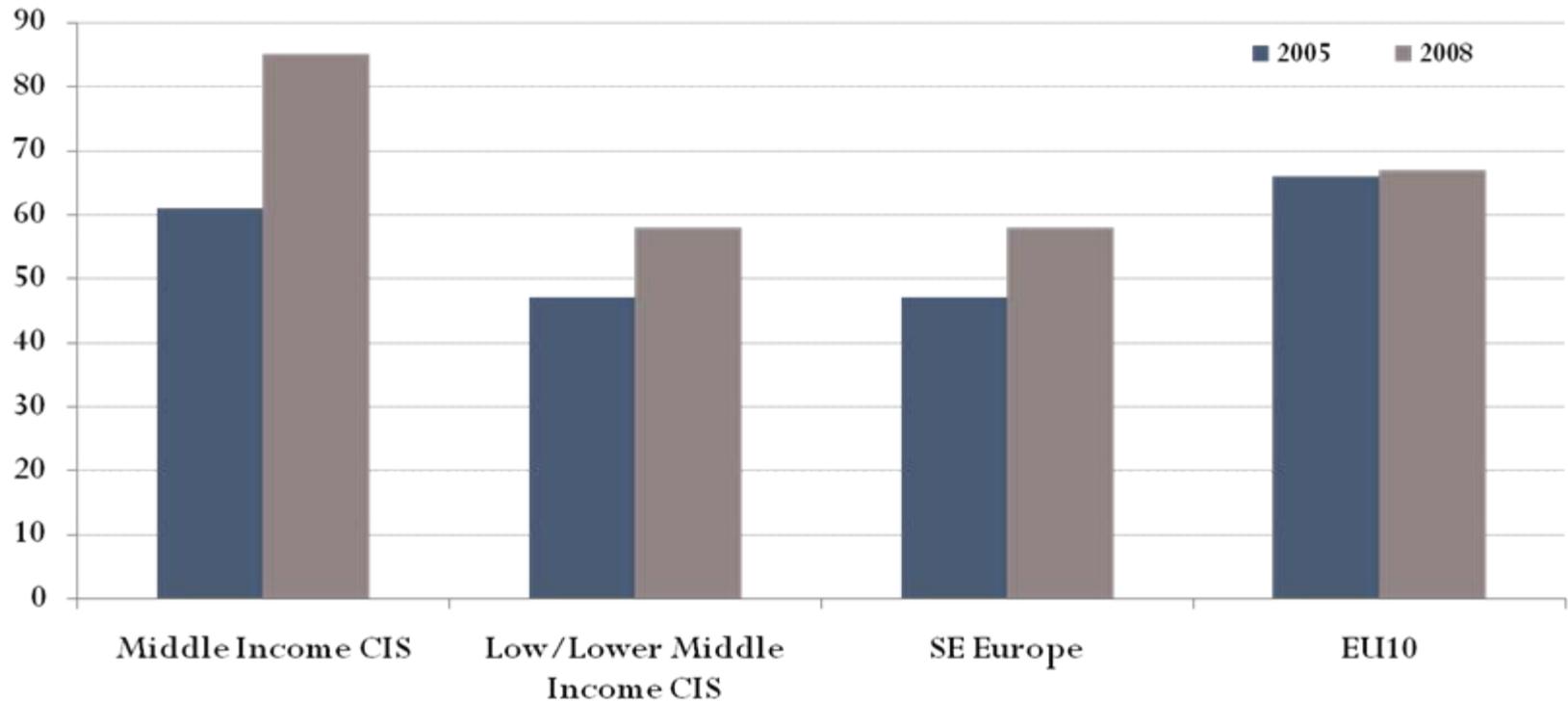
ECA's spending on social security resembles that in wealthier countries

Spending on social assistance and insurance, % of GDP; most data from 2000 to 2003



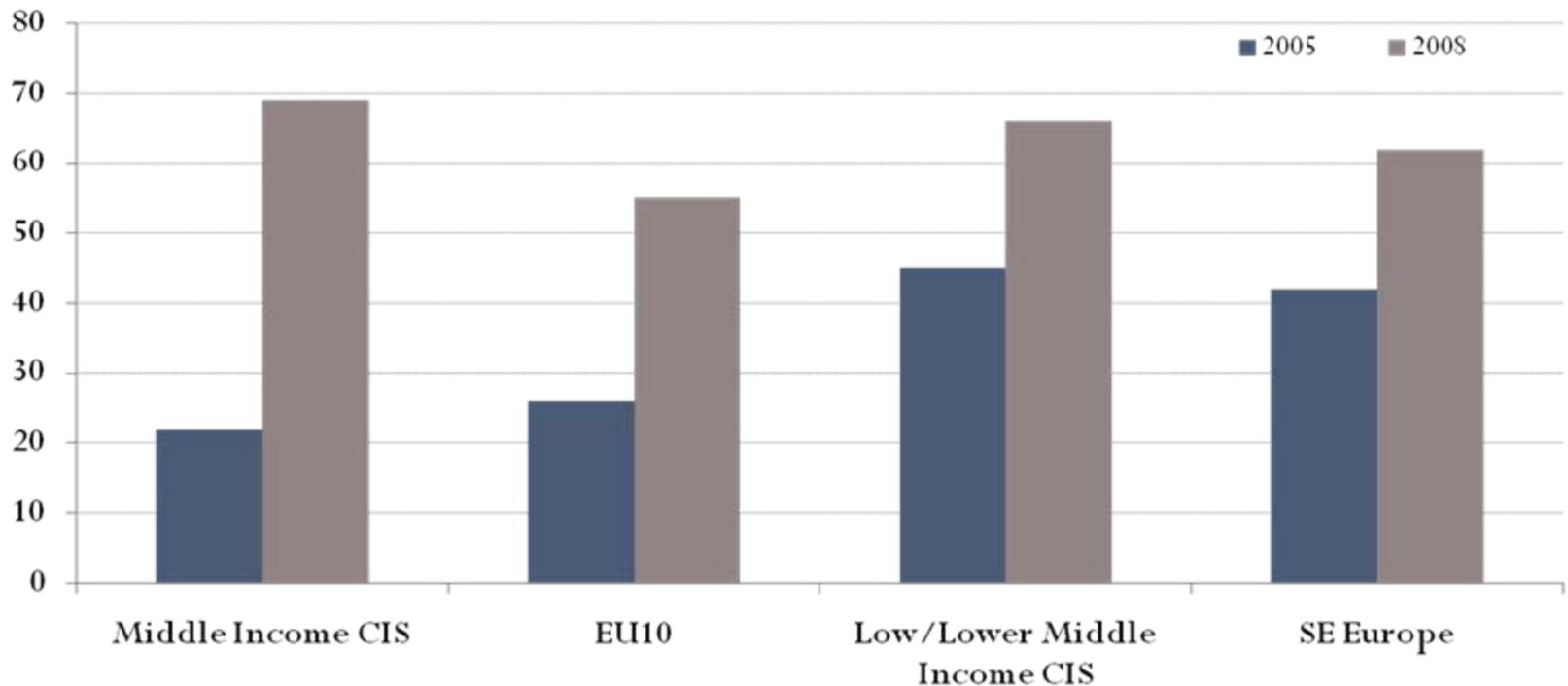
More pressure to invest in education

More enterprises are complaining that the skills of workers are becoming an obstacle for business



More pressure to invest in infrastructure

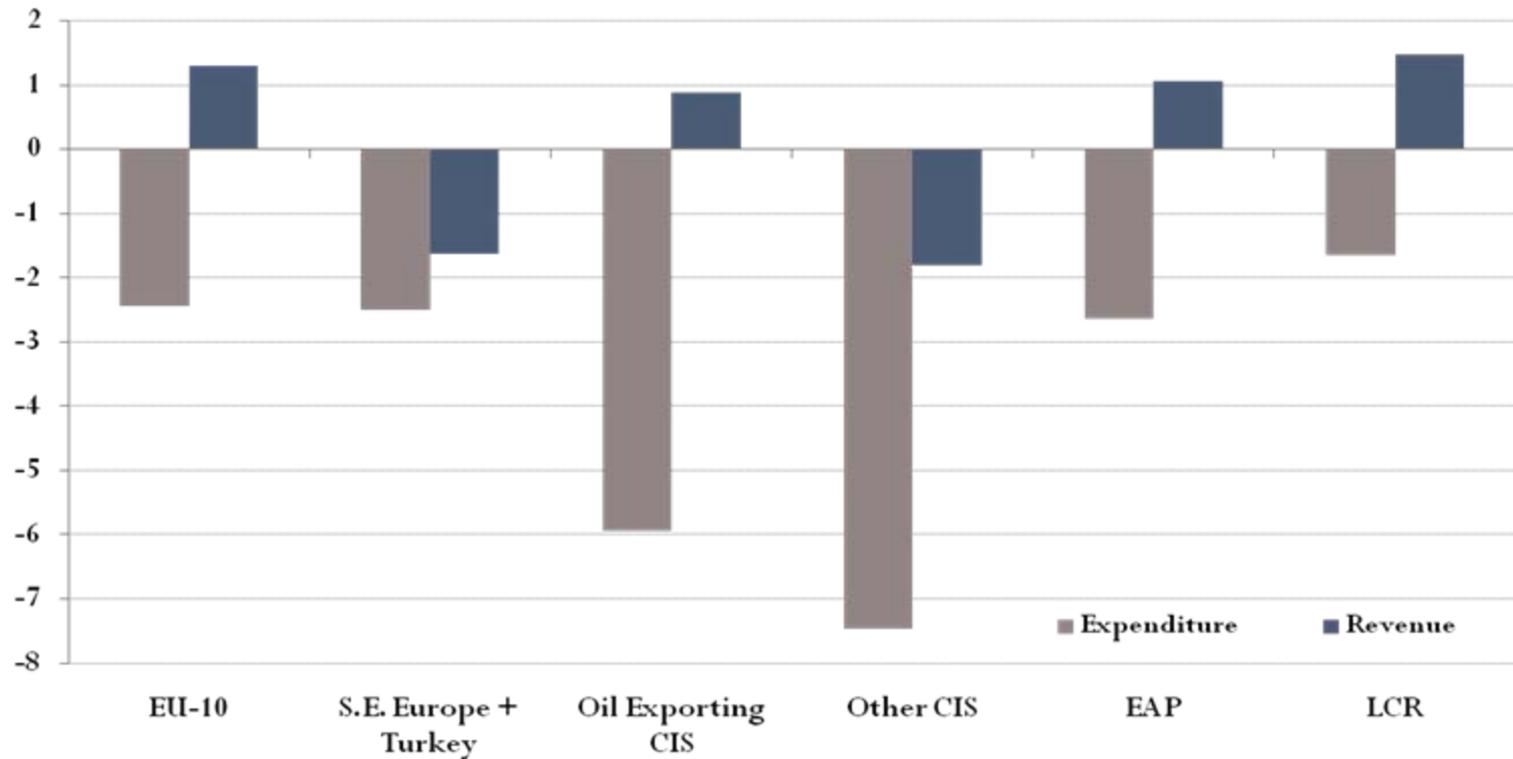
More enterprises are complaining that electricity is becoming an obstacle for doing business



Divergence in region growing

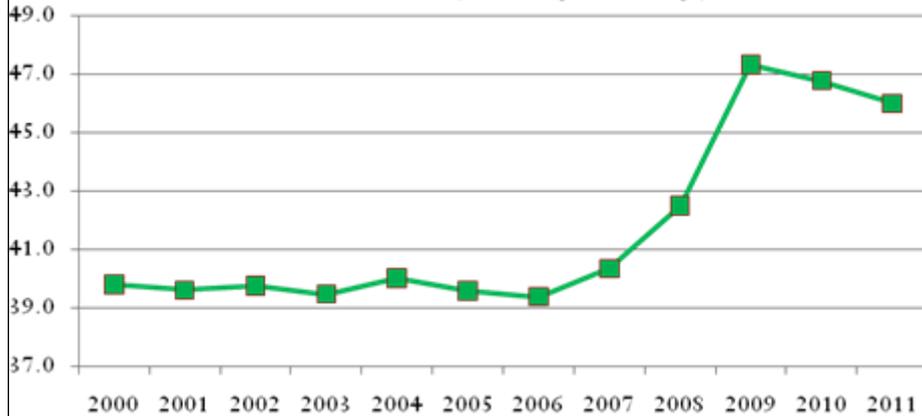
EU-10 adjustments will resemble those in middle income countries in East Asia and Latin America

Forecasted Adjustments (2009 to 2013)

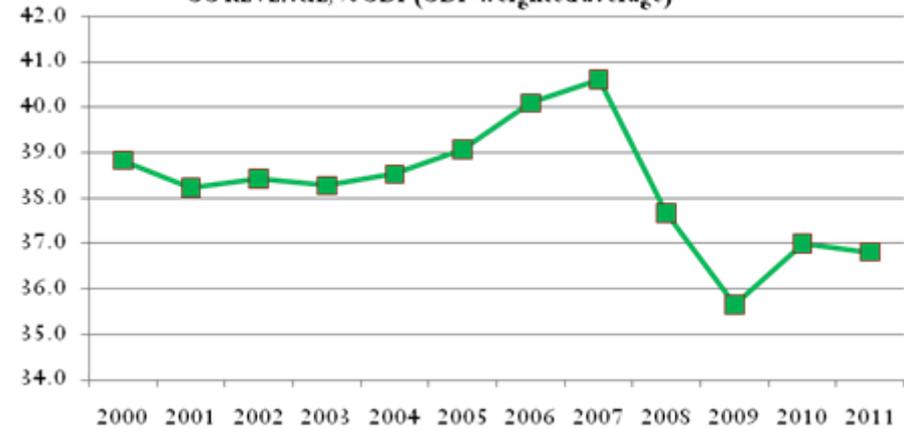


Fiscal Developments in Some European countries troubling: (PIGS)

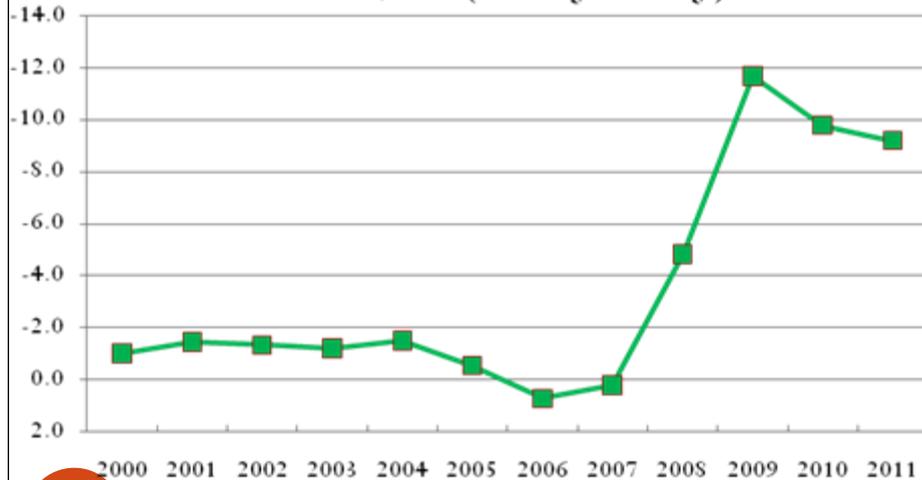
GG EXPENDITURE, % GDP (GDP-weighted average)



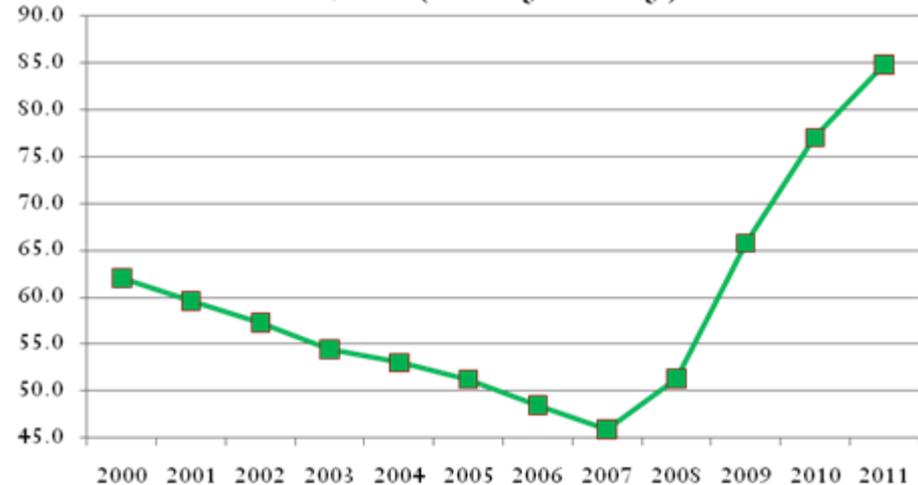
GG REVENUE, % GDP (GDP-weighted average)



GG BALANCE, % GDP (GDP-weighted average)

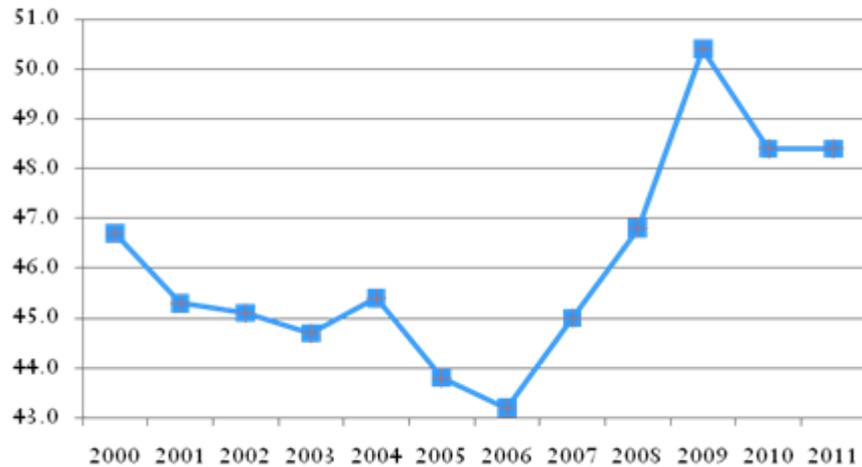


GG GROSS DEBT, % GDP (GDP-weighted average)

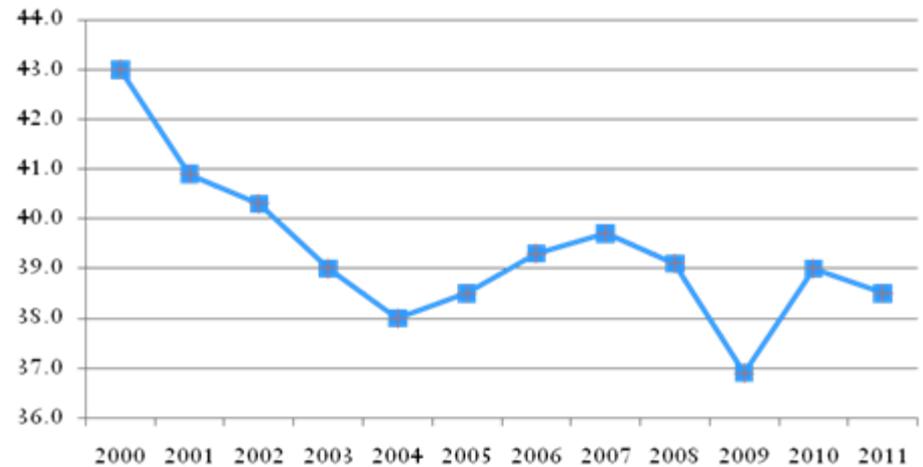


Greece: One of the Weakest

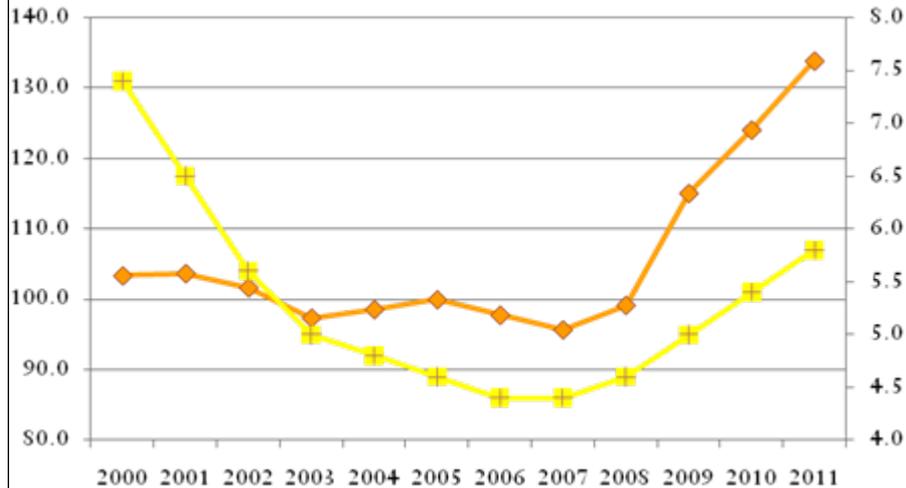
GREECE: GG EXPENDITURE, % GDP



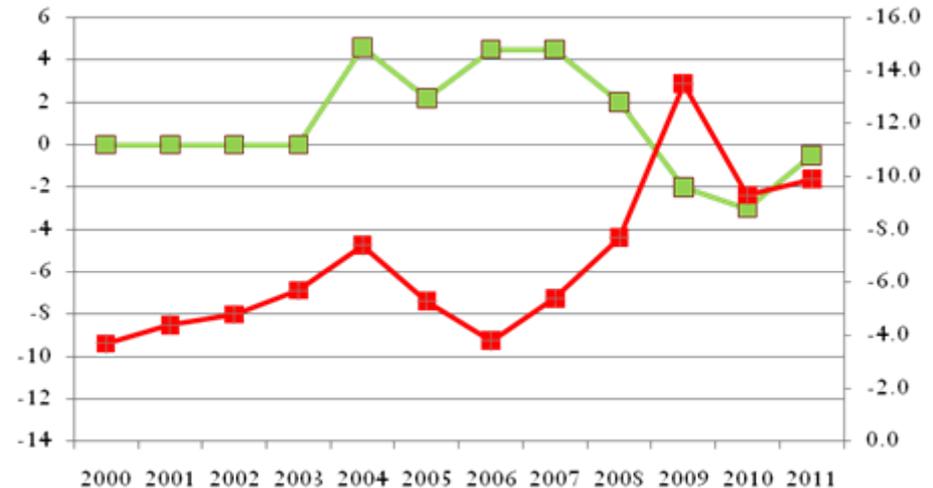
GREECE: GG REVENUE, % GDP



GREECE: GG GROSS DEBT AND INTEREST, % GDP



GREECE: GDP GROWTH AND GG BALANCE, % GDP



◆ Gross Debt ■ Interest (Right Axis)

■ GDP Growth ■ GG Balance (Right Axis)

Western Europe

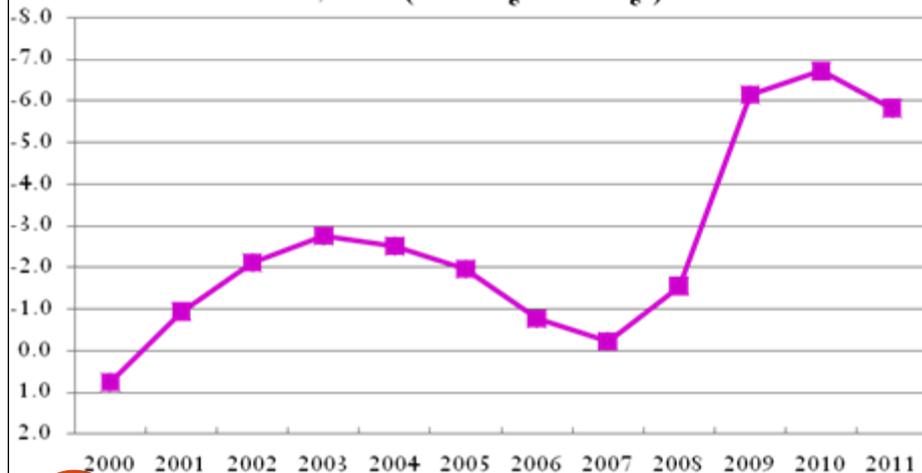
GG EXPENDITURE, % GDP (GDP-weighted average)



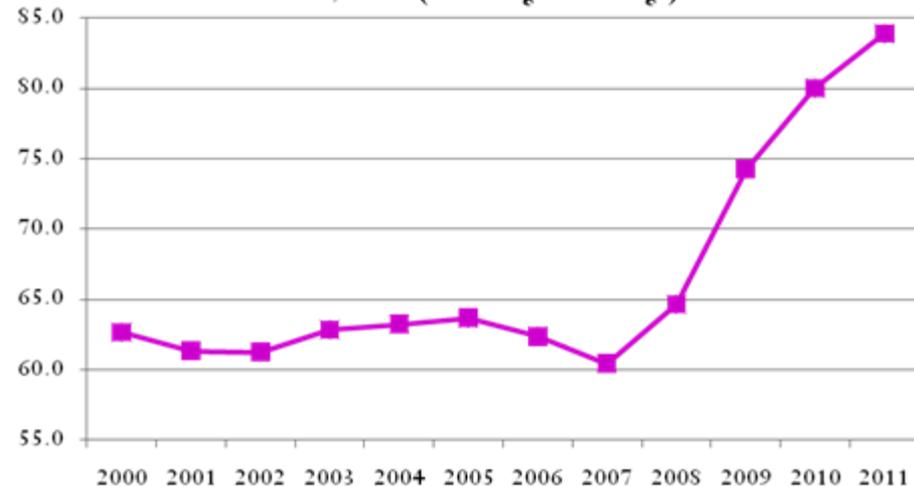
GG REVENUE, % GDP (GDP-weighted average)



GG BALANCE, % GDP (GDP-weighted average)



GG GROSS DEBT, % GDP (GDP-weighted average)

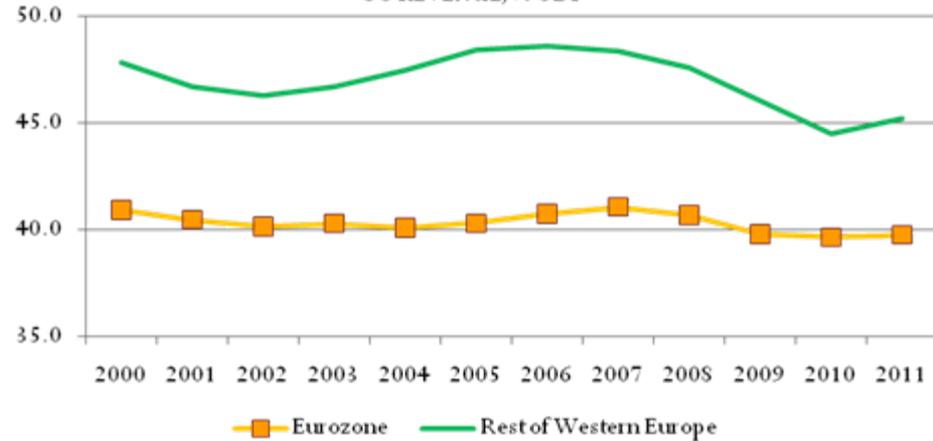


Eurozone versus Non-Eurozone

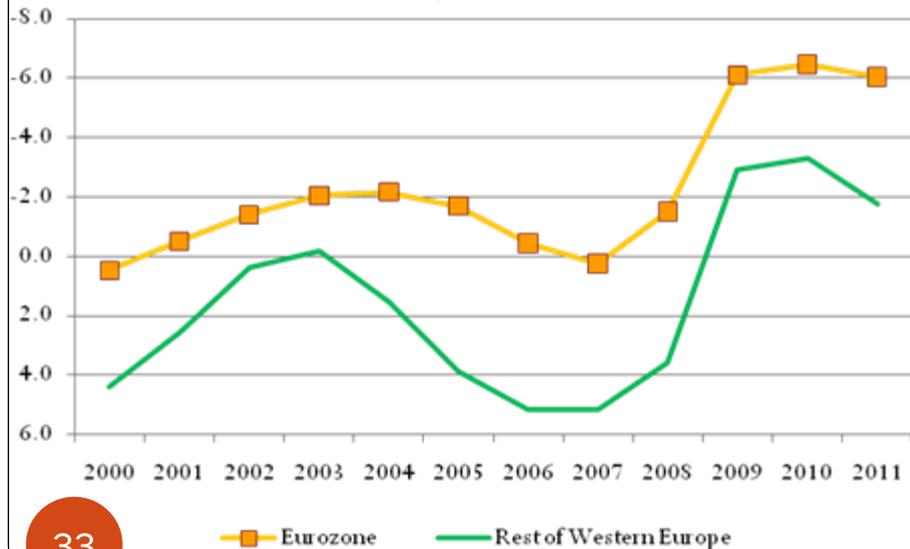
GG EXPENDITURE, % GDP



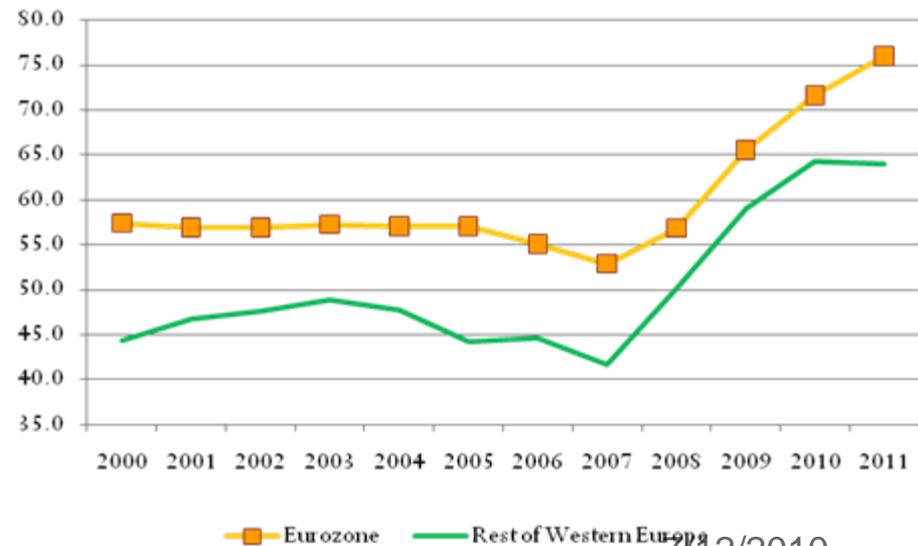
GG REVENUE, % GDP



GG BALANCE, % GDP



GG GROSS DEBT, % GDP



Fiscal consolidation

- **Current external situation not promising with Eurozone developments**
- **Requires making social sector reform a priority in many countries**
- **Requires reducing energy subsidies in much of the former Soviet Union**
- **Requires exit strategies from fiscal stimulus in oil and gas exporting countries**

Post-crisis pressures

- **Slower growth** likely for most economies
- Possibility of longer period of uncertainty- Greece and others
- Many governments will be **fiscally weaker**
 - Public debt levels will be higher after the crisis, additional tax potential unclear
- More pressure to address **climate change**
 - Pressure on emerging Europe to mitigate, on Eurasian countries to adapt

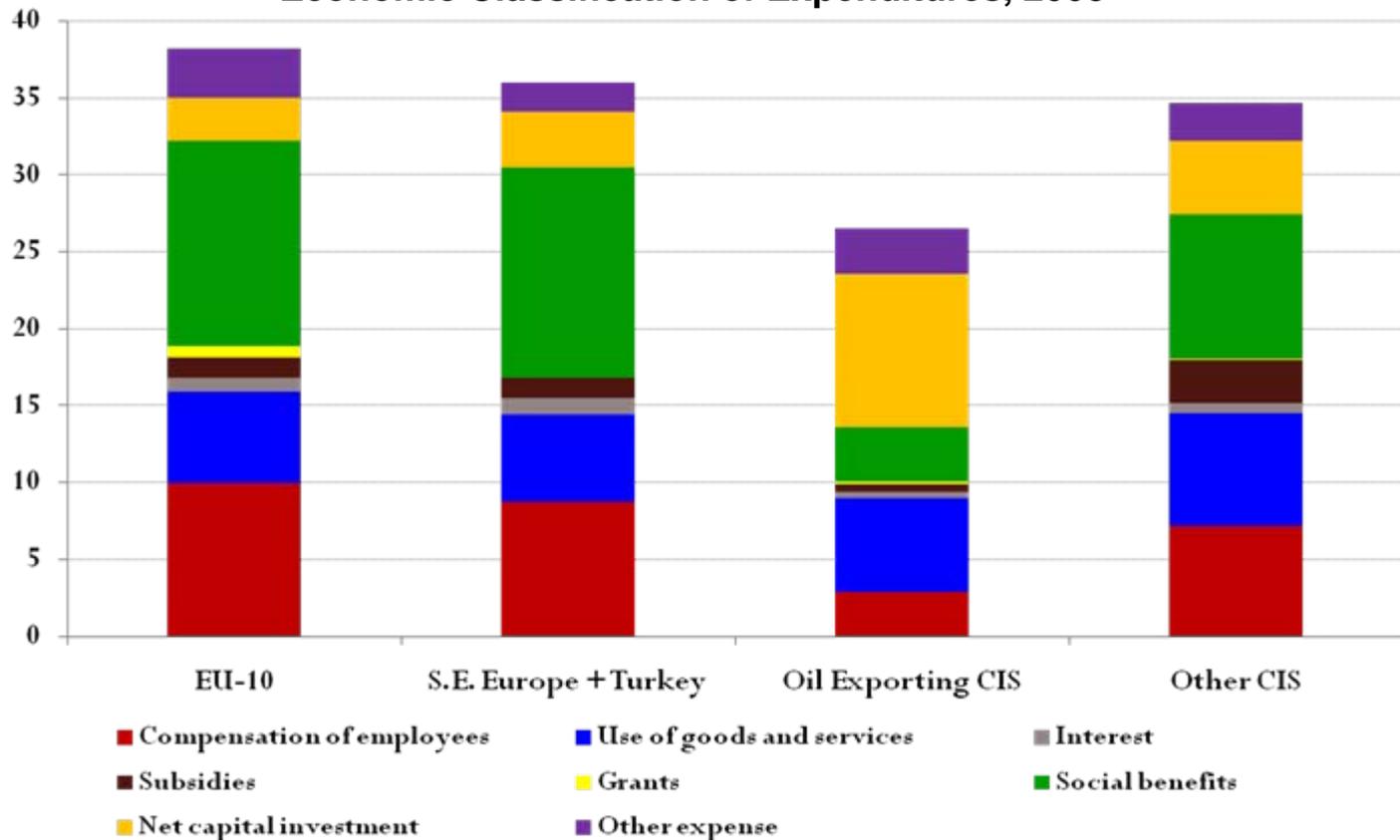
Elements of high quality fiscal consolidations

- **Crisis related.** Evidence points to crisis-related origins of high quality fiscal adjustments (World Bank 2007, OECD 2007, IMF 2007).
 - Implication: Begin reforms now
- **Expenditure focused.** Spending efficiency efforts more growth-enhancing when recurrent expenditures are targeted rather than capital spending.
 - Implication: Target social spending and public wage bill
- **Incrementally implemented.** Realistic frameworks and good public financial management systems to set priorities and enforce adjustment.
 - Implication: Improve budgetary and public financial management policies

Social benefits and wage bills are high in the west

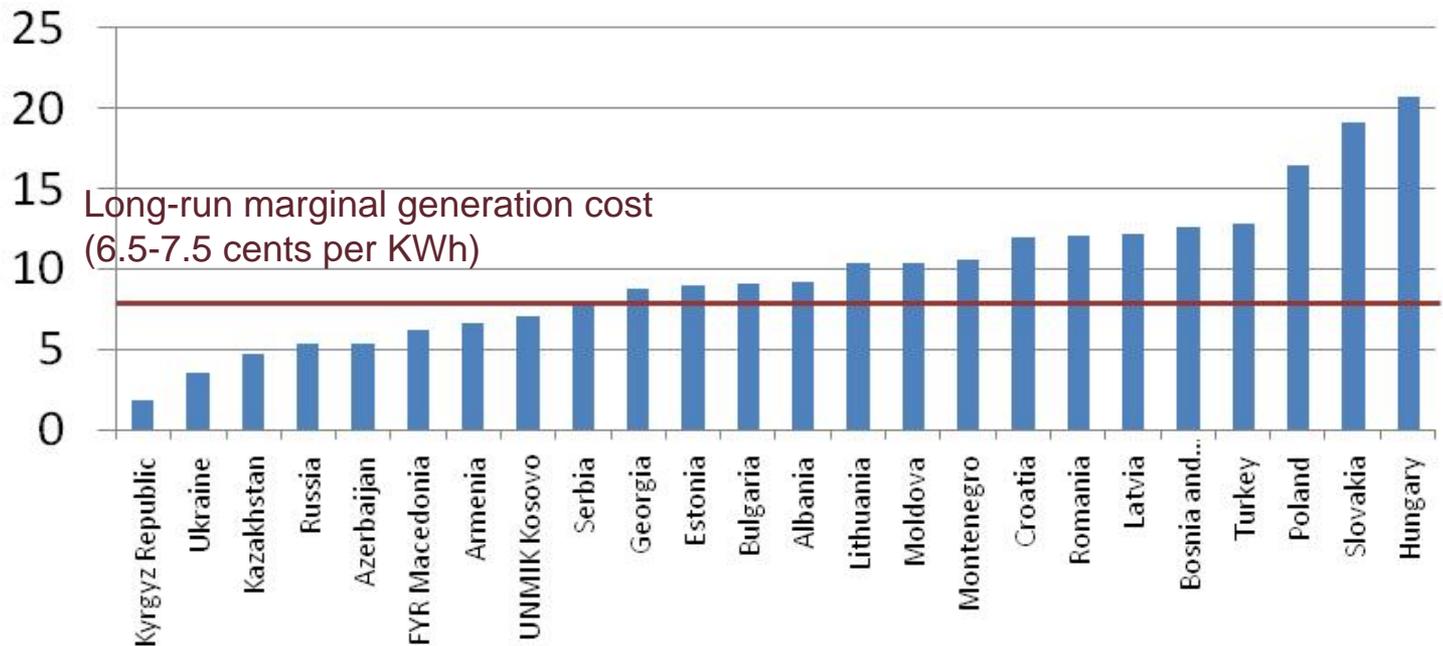
Social spending and employee compensation dominates the budget

Economic Classification of Expenditures, 2008



Energy subsidies are big in the east

Energy is priced below cost in much of the former Soviet Union



Source: ERRA Tariff Database; weighted average electricity tariffs for residential consumers in 2008, US\$ cents / KWh

Addendum: Poland

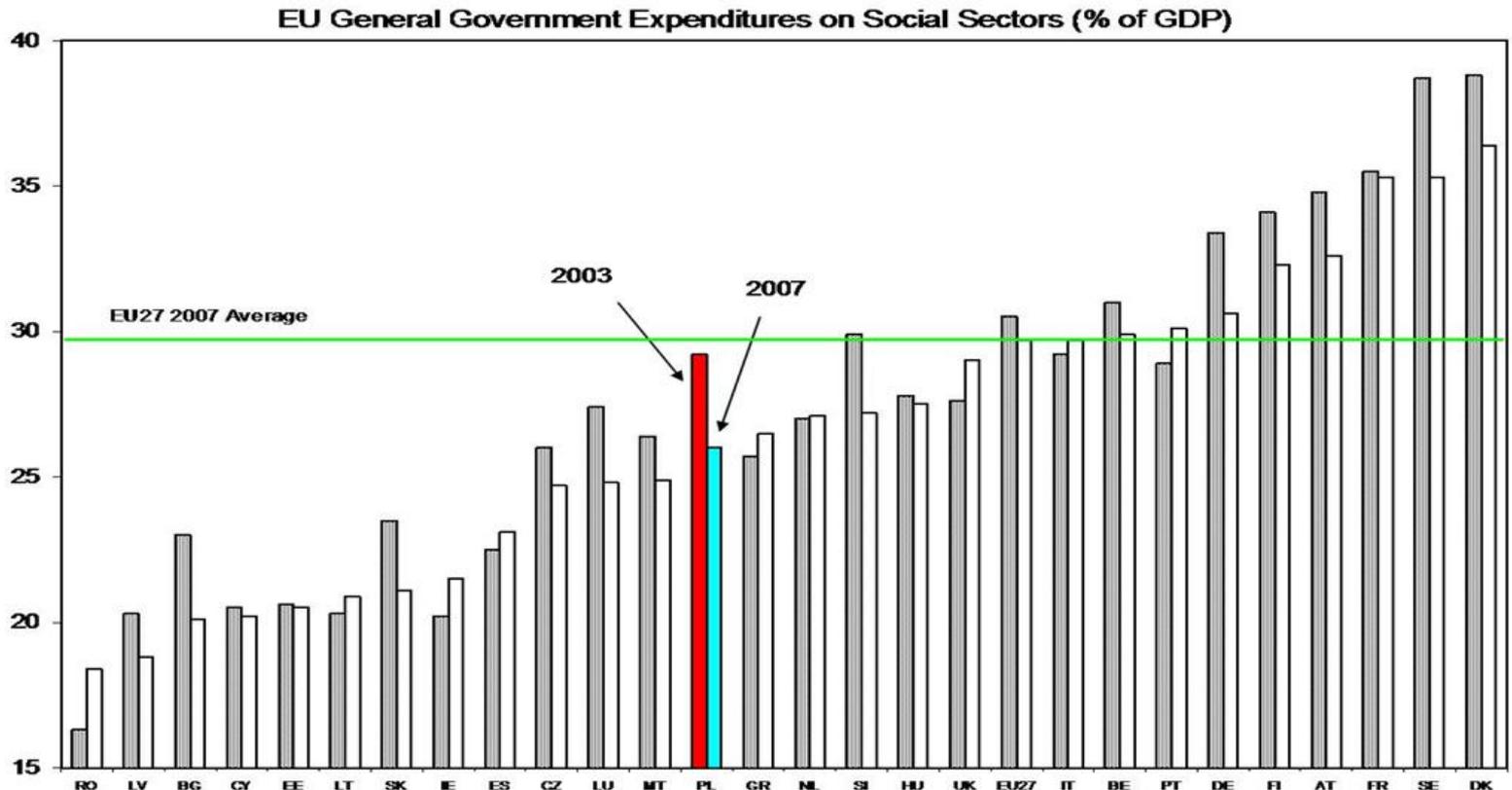
- **Fiscal deficits steadily fell from more than 6 to less than 2 percent of GDP between 2003 and 2007**
 - This despite shift to funded public pensions that costs about 3.0 percent of GDP annually
- **Revenues fell marginally from 40 to 39 percent of GDP between 2007 and 2009**
 - Poland only country in the EU to avoid recession
- **Fiscal deficit rose from 2 to 4 to 7 percent in 2007, 2008, and 2009, and expected to be greater than 6 percent in 2010**
 - Government spending rose from 42 to 45 percent of GDP between 2007 and 2009, and expected to be 46.5 percent in 2010

Poland: measures

- **Euro adoption objectives and desire to conform to national public debt ceiling driving reforms**
 - Aim to lower deficit to 3 percent of GDP by 2012
- **Social spending is high relative to other countries**
 - Social sector spending is 26 percent of GDP
 - Ratio is down from 29 percent in 2003
- **Fiscal consolidation can be done through three “big ticket” items:**
 - Social security benefit tightening and changing indexation: 1.2 percent of GDP
 - Public wage bill controls: 0.8 percent of GDP
 - Education funding to reflect demographics: 0.5 percent.

Poland: Social sector reforms

Social spending levels varied between 20 and 40 percent of GDP in the European Union in 2003-2007



Note: Spending on pensions, education and health, and assistance

Conclusion

- **Before the crisis:** Between 2000 and 2007, buoyant revenues allowed spending increases—improved fiscal balances masked greater inflexibility.
- **During the crisis:** Revenues fell in much of the region, spending was steadied by automatic stabilizers in most and stimulus spending in a few—fiscal balances deteriorated.
- **After the crisis:** Crisis made fiscal reform priorities clearer and more differentiated—fiscal futures could diverge even more after 2010 depending on pace of fiscal consolidation.