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Recession in South East Europe: Is there some space for policy manoeuvre?

The majority of countries in South East Europe (SEE)[1] have been living above their means, neglecting the necessity for fiscal consolidation, lagging behind in institutional reforms and now, in the recession, they cannot afford fiscal stimulus. Unfortunately, these countries do have to engage in fiscal retrenchment. This text tries to investigate the possible space for policy manoeuvre. It argues for more cautious monetary policy, elaborates the challenges of fiscal policy and gives some recommendations for one of the countries – Croatia – hoping that some of the suggestions might be found of relevance in some other SEE countries.

Living above their means

As stated for Croatia many times already (e. g. Ott, 2009), the majority of SEE countries are confronted with problems that they should have tackled a long time ago as they have been living above their means for too long and now they have to pay international and domestic bills that are becoming more and more expensive. This can easily be supported by the following considerations:

- The estimate for the average general government expenditures across the region in 2007 was 40% GDP (ranging from 48% in Croatia and 45% in Macedonia to 29% in Albania);
- Estimated regional budgetary deficit for 2008 was 1.5% GDP (from 3.7% surplus in Bulgaria to 5.2% deficit in Albania);
- It is not strange that the average public debt in the region in 2008 was 31% GDP (the highest was 54% in Albania and the lowest 14% in Bulgaria);
- However, the average external debt in the region for 2007 was 42% GDP (105% in Bulgaria and 89% in Croatia as against 18% in Montenegro and 26% in Albania).[2]

Neglecting fiscal consolidation

Unfortunately, in the times of prosperity, while GDP growth was favourable – averaging for the region 5.7% per year in the period 2001-2007 – the general government expenditure share of GDP across the region decrea-

[1] For the purpose of the text SEE countries include Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, and Serbia.
[2] All data in the text if not expressly mentioned otherwise are from EBRD (2008).

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sed less than one percentage point on average. These shares even increased 5 percentage points in Montenegro and 4.4 percentage points in Serbia. Although there are exceptions – such as Macedonia where the expenditure share of GDP decreased 6 percentage points – it is obvious that the majority of SEE governments were not concentrated enough on fiscal consolidation, on decreasing public expenditures and on carrying out the necessary institutional reforms.

Lagging behind in institutional reforms

The EBRD (2008) nicely explains the pace of institutional reforms in SEE countries. Average transition scores within the region vary: Bulgaria, Croatia and Romania scoring around 3.5, Albania and Macedonia around 3, and Bosnia and Herzegovina, Montenegro and Serbia around 2.8.[3] Particularly indicative is that all SEE countries score rather poorly in governance and enterprise restructuring (only Croatia scoring 3, all others scoring from 2 to minus 3).

Now, in the worst possible circumstances countries have to

- *Improve competitiveness* in which they all score poorly (only Croatia and Romania scoring a meagre minus 3, all others scoring around 2);
- *Decrease budget deficits* – the 2008 regional average budgetary deficit was equivalent to »only« 1.5% of GDP. However, the budgetary deficit was 5.2% in Albania, 2.8% in Romania and 2.5% in Serbia, while only Bulgaria and Montenegro had budgetary surpluses;
- *Decrease current account deficits* – the 2008 regional average current account deficit was equivalent to 17% of GDP, ranging from 37% in Montenegro to 9.7% in Macedonia. None of the SEE countries had current account surpluses in that year, or in the ten previous years (and probably even longer);
- *Accumulate funds to repay their debts.*

Fiscal retrenchment instead of fiscal stimulus

Obviously there is no place for fiscal stimulus or for discussions about what the USA and Germany are doing at the moment. The majority of SEE countries are constrained with current account deficits, high indebtedness, unbalanced budgets and some of them with unfavourable demographic prospects. Acquiring funding abroad is difficult and expensive because of poor fiscal situation which is affecting their credit ratings. Furthermore, like many other emerging market economies, SEE countries suffer from »original sin«, i.e. they are not developed enough to be able to borrow abroad in their own currencies.

With high government expenditures SEE countries need fiscal retrenchment.

When necessary governments could or even should support the banks, but supporting companies and industries in these circumstances might be very tricky:

- Nobody knows how long this recession might last and how much any possible fiscal stimulus might cost SEE-country taxpayers.
- Is the recession really the source of the problems of these companies or are some of them doomed to fail anyway?
- Lobbying, corruption and nepotism are already pronounced in the region and fiscal stimulus might bring additional injustices and inefficiencies, a surge of corruption, as well as protectionism in neighbouring countries.

Thinking about Croatian tourism for example, nobody knows how many tourists will not come to Croatia because of the recession and how many because of inadequate services and high prices. Why should the Croatian tourist sector try to be more productive and more efficient than for instance the Greek tourist sector if Croatian taxpayers are willing to pay for the difference in prices caused by this sector’s low productivity and inefficiencies?

Policy space: Does it exist?

A draft document prepared by the OECD for a recent meeting of the SEE Investment Committee (---, 2009) enumerates various possible and actual measures that could be, and in some cases have been, undertaken by SEE countries. When it comes to the currency depreciation it concludes that »however, for some countries depreciation is not an option because their currencies are pegged to the euro«. One can only agree with that statement. It is true that all SEE countries have to improve competitiveness; however when countries have low efficiency and poor productiveness their competitiveness cannot be remedied by currency depreciation, irrespective of whether it is pegged to the euro or not. Besides,

[3] EBRD transition indicators show countries’ positions on the transition path and enable cross-country comparisons. The indicators are in a range from little or no progress in transition (indicator 1) to standards equivalent to those of a hypothetical advanced market economy (indicator 4 plus).

currency depreciation can invoke protectionism in other countries and cause problems with repayment of loans denominated in foreign currency. In the end, depreciation could provoke inflation and further destabilize fragile economies. Competitiveness could be improved through enabling conditions for more open trade and investment and for increasing efficiency and productiveness. Measures could involve more flexible labour laws, more flexible working hours, and in some countries a better basic infrastructure.

Time for a more cautious monetary policy

As reviewed in the aforementioned OECD draft document, among the possible monetary measures that could be contemplated – or have been implemented in some SEE countries – are the following:

- »Measures to increase liquidity and boost credit to households and firms, such as cutting main policy rates or reducing minimum reserve requirements«. Increasing liquidity and improving the structure of the debt are certainly good measures. However, having in mind the already high indebtedness, one should be careful and think of the optimal level of indebtedness too.
- »Measures to encourage lending in local currency«. The same as above; it is good to improve the structure of the debt. However, although it might seem that, in view of the level of development and total indebtedness, particularly of the private sector, these countries did not step over the optimal level of indebtedness, they should still carefully watch the optimal level of their indebtedness.
- »Measures to prevent potential bank runs, like increasing guaranteed sums or scrapping taxes on savings«. Countries have to have stable banking systems and measures aimed at stabilizing banking systems could be considered a horizontal aid that benefits everybody. In that sense scrapping taxes on savings are welcome, while increasing guaranteed sums could be tricky. In countries with poor confidence in banks, increased guarantees might improve trust. However, they might also increase moral hazard.
- »More cautious monetary policy« is certainly the best advice possible in these times, particularly in countries in which there are big pressures to depreciate the local currency.

Challenges of fiscal policy

When it comes to fiscal policy, the same OECD document emphasizes the limited room for fiscal manoeuvre for more or less the same reasons as stated above and again enumerates possible and actually undertaken measures.

Certainly the best measure is, as the document states, to »increase spending efficiency by e.g. cutting public administration costs, urging state-owned enterprises to devise saving plans or reducing the rate of public sector wage increases and pensions«. However, weak, usually coalition, governments tend to be blackmailed by users of public funds. At the same time, public sector salaries and social benefits – which in the majority of SEE countries comprise the biggest share of expenditures – are presented as mandatory budgetary items, which is actually not true. Only debt payments are mandatory items and even they could be postponed, although it would not be wise to suggest that at the moment. Increases in public sector salaries and social benefits are the consequence of long-term pressures from trade unions, pensioners and other users, and in some of these countries also of war veterans. As these agreements were made and decisions and laws were passed, so new agreements could be made and new laws passed. But just as these agreements and decisions were made and laws were passed, so new agreements and laws could be put in place in their stead. Even without agreements, governments could pass new laws, as the government of Ireland did recently when it could not reach consensus for fiscal consolidation with trade unions and employers.

And when governments decide to cut public servants' salaries (for example) it is wrong to promise an automatic increase of salaries when the economy recovers, to guarantee jobs in the public sector and to decrease salaries by an equal percentage for everybody, as in that case, sooner or later, countries will find themselves in the same situation again. Unfortunately, the new proposal of the law on public sector salaries in Croatia[4] promises exactly that: keeping jobs and full employment, for at least two years and it is obvious that salaries will be decreased proportionally.

Some SEE countries like Macedonia and Montenegro are giving tax breaks and capital investment tax expenditures to some industries like construction. Unfortunately, such selective preferential treatments might further increase distortions and inefficiencies and deepen budgetary imbalance. Some countries, like Serbia, have

[4] Nacrt prijedloga zakona o osnovici plaće u javnim službama s nacrtom konačnog prijedloga zakona, March 2009. http://www.vlada.hr/hr/naslovnica/sjednice_i_odluke_vlade_rh/2009/74_sjednica_vlade_republike_hrvatske

introduced temporary new property, luxury items and capital gains taxes. This kind of populist, marginal tax cannot substantially increase budget revenues. When governments decide to increase taxation the best way is to increase the standard VAT rate and, where they are present, replace the zero rates with the reduced VAT rates. The latter, for countries that are aligning their tax systems with the EU requirements, is a necessary move anyway. VAT is the highest yielding, simplest, most neutral, the least expensive-to-collect kind of taxation and is most appropriate for the necessary adjustments. Although one should always argue for the lowest possible taxation, when governments do not have the guts to decrease expenditures, increasing VAT seems like the best idea. Revenues and expenditures have to be balanced and times of scarce and expensive capital are not opportune for incurring new debts. According to Mihaljek (2009) the risk premium on external borrowing for the government of Croatia has increased five times since mid 2008 and twenty times since mid 2007.

In describing current policy responses, the OECD draft paper notes that »Some SEE countries are additionally funding state-owned development banks to facilitate lending to small and medium size enterprises, some even directing funds to specific industries or export oriented sectors«. It should be observed that the sources for these funds are questionable, with already overstretched budgets, and that such measures could cause further distortions, inefficiencies and increase corruption. For the same reasons it does not seem wise to subsidize interest rates on loans to firms and on credits to households (e.g. in Serbia which already has external debt of around 65%).

»Some countries are increasing assistance to the poorest income groups... as lower income groups typically have a higher propensity to consume«. It is true that countries should support the poorest and carefully target the neediest. If overlooked, social aspects of the recession might in some of the countries cause unrest which would destabilize these countries and adversely affect not only political but also the economic situation, e.g. causing a further decrease of foreign direct investments. However, the competencies of these countries' administrations and necessary data-bases for targeting this kind of assistance might be questionable.

Can recommendations meant for Croatia ring true for other countries of South East Europe?

As it would seem preposterous to give unique suggestions to all countries across the region, the rest of this text will make basic recommendations for the country the author is best acquainted with, in the hope that they might be found of relevance for some other countries as well.

The situation in Croatia is more similar to that in other SEE countries than many Croats are aware or would like to admit. The main problems in Croatia lay in high public expenditures, high budget deficit, a high current account deficit, high public debt, high external debt, high unemployment and poor demographic prospects. The necessary steps to remedy these problems – cutting public expenditures and carrying out institutional reforms i.e. reforming public administration, health, pension and welfare systems – despite of or even because of the recession are obvious.

In a short run, as soon as possible, Croatia should decrease its public expenditures, targeting the most burdensome public sector salaries and social benefits that make up 70% of total government expenditures, but also state aid and local government borrowing. If government cannot make such tough decisions it should as soon as possible increase the standard VAT rate and replace the zero rates with reduced VAT rates. Incurring further debts at extremely high prices is highly irresponsible to the new shrinking generations of further taxpayers.

In the long run, the government should concentrate on structural reforms in employing, laying off and rewarding public sector employees plus reforms of welfare, health, education, pensions, state aid, and local and regional administrations. Government should also better plan its finances, stop running them on a daily basis and stop accommodating to the pressures of various interest groups.

Short term decreases of public expenditure will not suffice without long-term reforms.

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