The financial furmoil in central and eastern Europe and fiscal policy in Croatia

Mihaljek, Dubravko

AN OCCASIONAL PUBLICATION OF THE INSTITUTE OF PUBLIC FINANCE

NEWSLETTER

INSTITUT ZA JAVNE FINANCIJE

No. 40 May 2009 ISSN 1333-4417

Institute of Public Finance • HR-10000 Zagreb, Smičiklasova 21, Croatia

P. O. Box 320; Phone: (385 1) 4886 444; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

Dubravko Mihaljek[1]

The financial turmoil in central and eastern Europe and fiscal policy in Croatia

Central and eastern Europe (CEE) is the emerging market region hardest hit by the spillovers of the financial crisis from the advanced economies so far. It has been affected so hard because it had financed its long expansion to a great extent by foreign borrowing, and many countries, including Croatia, had accumulated large external and internal imbalances in the process. As external sources of funding began to evaporate in the second half of 2008, it was only a question of time before private consumption and investment in the region would start to adjust. The adjustment accelerated in late 2008 and early 2009 as western European countries fell deeper into recession and sharply reduced their demand for imports from CEE. The public sector in many CEE countries largely ignored these events for several months, but eventually started to adjust as well. In particular, the public sector in Croatia postponed adjustment until the spring of 2008, unnecessarily bringing into question the maintenance of macroeconomic and financial stability. While some initial steps have been taken to remedy the situation, it remains to be seen how the revised budget for 2009 will be implemented and how the resulting deficit will be financed in a very difficult global financial environment.

1 Introduction

The idea for this *Newsletter* first appeared in March 2008, when the Croatian parliament adopted the budget for 2008 and the Institute of Public Finance published its first *Press Release* (Bajo, 2008). At the time, Croatia, like the rest of central and eastern Europe (CEE), was still spared the more serious spillovers from the financial turmoil in US and European financial markets. Growth was relatively strong and the main policy concern was inflation, which accelerated sharply due to the pick-up in food and oil prices and tight labour markets.

The budget for 2008 envisaged a reduction in the general government deficit to 2.3% of GDP from 2.6% in 2007. This gradual reduction was widely viewed as appropriate. There were a few analysts advocating a sharper reduction (see in Pavić, 2008), but many commentators and politicians were also calling for an *increase* in the deficit, arguing that the budget was not »developmental« enough (see in Varošanec, 2008). I was struck by the disconnect between such claims and the clear signs of tightening in global financial markets, and suggested to the colleagues at the Institute of Public Finance a brief note

[1] Senior Economist, Bank for International Settlements (BIS), Basel. The views expressed in this paper are those of the author and should not be attributed to the BIS.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: http://www.ijf.hr/newsletter.

on this issue. My idea was to argue for a sharper deficit reduction on the grounds that this was both possible and more efficient: possible because the baseline scenario was one of an orderly slowdown in exports, domestic demand and credit growth; and more efficient because it was better to consolidate public finances when the times were still good rather than later, when it would became more difficult and costlier to finance the deficit.

However, just as the authorities procrastinated with fiscal adjustment, I did with the writing of this *Newsletter*. Three months after the original budget was approved, the government adopted a revised budget for 2008, based on a new methodology for recording government transactions harmonised with EU standards (i.e. European System of Accounts, ESA 95). This made comparisons with budgets for previous years difficult, and allowed an increase in overall spending while keeping the reduction in the headline deficit unchanged at 0.3% of GDP. Namely, according to the ESA 95 methodology the 2008 general government deficit was projected at 1.3% of GDP, down from 1.6% of GDP estimated for 2007, even though the revised budget introduced higher spending on health care and new subsidies for households and businesses hit by food and energy price increases.

During the second half of 2008, the budget was largely outside the media attention. Data indicated that revenue collection in the first half of the year was strong, which made it easier to quieten concerns expressed by some analysts over an unusual, 24% increase in subsidies and current and capital transfers (EIZG, 2008). Moreover, the baseline scenario of an orderly slowdown in emerging markets played out fairly closely through September 2008. This further reduced the urgency for me to complete this newsletter.

But starting in October 2008 the CEE region got increasingly sucked into the global financial and economic maelstrom. As credit markets around the globe became dysfunctional in the aftermath of the collapse of Lehman Brothers, there was heavy and at times indiscriminate selling of emerging market assets.[2] CEE was hit particularly hard because it had financed its long expansion to a great extent by foreign borrowing.

This time the financial market tremors started affecting fiscal outcomes and policy in Croatia fairly quickly. Data for the third quarter indicated a sharp slowdown in revenue collection (from 8.1% in the second quarter, to 2.4% in the third). However, general government expenditure remained strong, growing 8% year-on-year in the third quarter (compared with 6.8% in the second quarter). The finance ministry resorted to very frequent and large T-bill issuances in the last quarter of 2008 and January 2009, suggesting that it started to face liquidity problems (EIZG, 2009b).

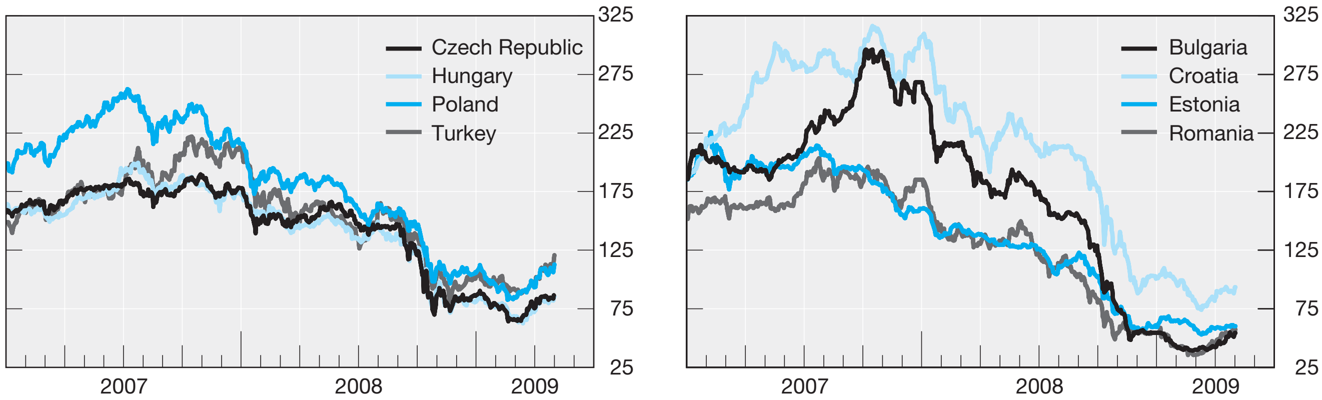
Against this background, the government initially proposed to reduce the budget deficit for 2009 to zero. However, the debate on this proposal turned out to be more intense than expected, involving social and coalition partners, economists, and government and parliament members. The most controversial topics were the public sector wage increase and the health system reform (Ott, 2008). The public sector trade unions opposed vehemently any limitation of the previously agreed 6% wage increase. And as in 2008, many commentators and politicians were still advocating an increase in the budget deficit (Šajatović, 2008), despite the clear signs that the crisis had worsened. The arguments ranged from oversimplified Keynesian thinking to naïve imitation (»All advanced economies are doing it«). In the end, the government decided not to break the collective agreement with the public sector trade unions for the sake of »social peace«. The 2009 budget thus envisaged a general government deficit of 1.2% of GDP, with both revenue and expenditure projected to increase by 5.2%.

But the criticism of yet another postponement of fiscal adjustment did not subside. Nor did real economy and financial market prospects get any better. On the contrary, in January and February 2009 it became clear that the state of the real economy was deteriorating much faster than anyone had anticipated, and that many borrowers, including governments, might run into difficulties with repaying or rolling over their debt. In mid-February, financial markets in the CEE region were close to a panic mood. The long-standing vulnerabilities were suddenly exposed in a much grimmer light than at any time since the Russian crisis of 1998.

At that point, the Croatian authorities seem to have finally acknowledged what some analysts have been arguing all along – that either expenditure needs to be cut or taxes increased (Ott, 2009; EIZG, 2009a). Accordingly, they started to revise the 2009 budget and in late March sent a draft of the revisions to the parliament. The draft revised budget envisages 6.4% lower revenue and 4.3% lower expenditure compared to the budget adopted in December 2008. At this writing it is not possible to assess how the revised budget, that will eventually be adopted by the parliament, will look like. In any event, the details of revenue and expenditure adjustments are

[2] Investment bank Lehman Brothers was one of the most important counterparties on global swap and derivatives markets, which are essential for normal functioning of traditional securities markets. Its default therefore triggered major disruptions in global financial markets.

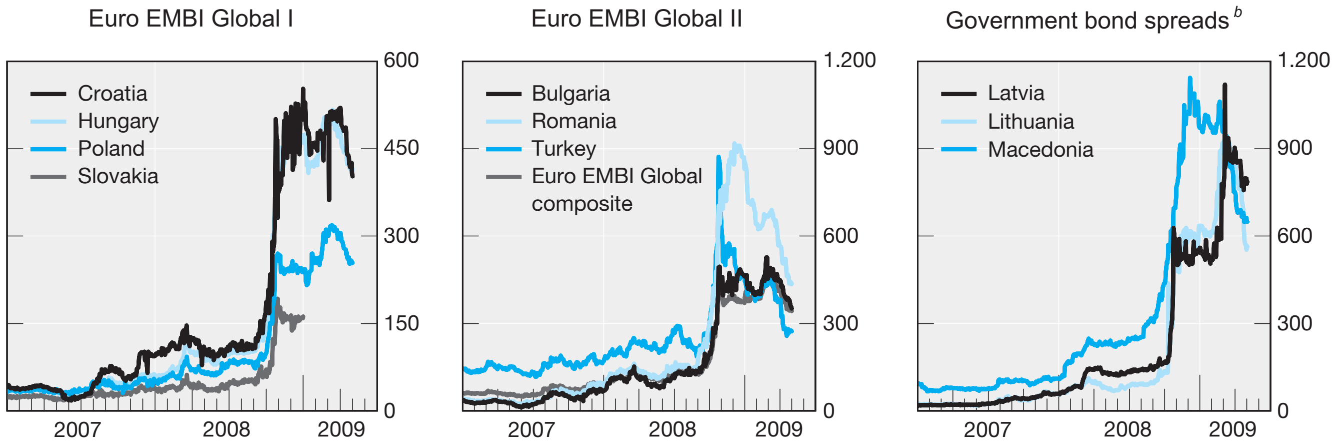
Graph 1 Equity prices[a]



[a] *January 2005 = 100; in local currency terms.*

Source: Datastream.

Graph 2 Bond spreads for selected countries[a]



[a] *Spreads over benchmark euro area bonds, in basis points.* [b] *For Latvia, 5-year bond; for Lithuania, 4-year bond; for Macedonia, 6-year bond.*

Sources: Datastream; JPMorgan Chase.

not the focus of this *Newsletter*; instead, it looks at two important issues that have not yet been thoroughly analysed in recent policy discussions: first, the scope for external financing of the budget deficit; and second, the scope for expansionary fiscal policies. Section 2 sets the scene with an overview of the latest financial market developments. Section 3 assesses recent developments and outlook for capital flows and external balances. Section 4 concludes with a discussion of the monetary and fiscal policy mix, and the macroeconomic and financial risks of a possible fiscal expansion.

2 The spread of the crisis to central and eastern Europe

The crisis in the main financial centres that began in August 2007 had for over a year only a moderate impact on CEE. Since October 2008, however, CEE has become one of the most affected emerging market regions. The crisis has spread in a rapid succession through equity, bond, foreign exchange and interbank markets, leading to a significant tightening of external financing conditions and a large-scale withdrawal of cross-border loans.

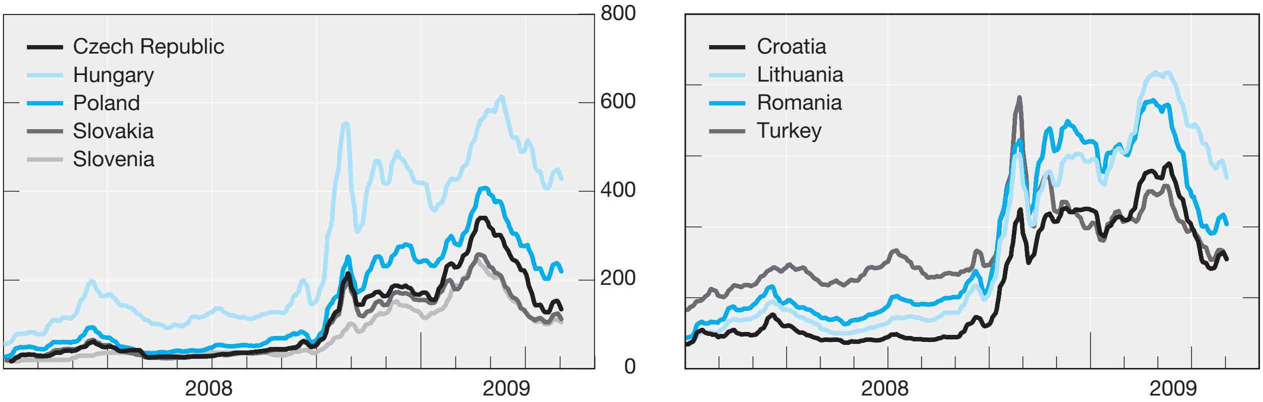
The first to feel the full force of the crisis were the **equity markets**. The slide in equity prices that began in different markets in mid- or late 2007, and continued at a more or less gradual pace through August 2008, turned into a veritable plunge in September and October, when prices fell by 50% on average, and by close to 60% in Croatia (Graph 1, right-hand panel). By mid-February 2009, CEE equities have on average lost 75% from peak values realised in 2007, and were back to the levels from 2004 or earlier. It is worth noting that Croatia had experienced the greatest increase in equity prices of all CEE countries: between January 2005 and mid-October 2007, equity prices in Croatia appreciated by 316% (Graph 1, right-hand panel), compared to the average of 230% for other countries in the region.

The next domino that fell was the CEE sovereign **eurobond market**. After the onset of the crisis in August 2007, spreads of widely traded central European sovereign bonds at first moved up gradually, from around 30-45 basis points, to 50-100 basis points in September 2008 (Graph 2, left-hand panel). In south-eastern Europe and the Baltics, the spreads had widened by an additional 50-100 basis points over this period, reflecting greater concerns over external financing (Graph 2, centre and right-hand panels).

However, the worsening of the crisis in September and October 2008 led to unexpectedly sharp widening of bond spreads. In particular, for countries with larger external imbalances, the spreads jumped in parallel with escalating problems on the Hungarian forint market (see below), in the case of Croatia, from 100 basis points in early September, to 550 points at the end of December (Graph 2, left-hand panel). In **credit insurance markets**, credit default swap spreads for sovereign bonds of highly indebted countries such as Croatia, Hungary, Romania and Turkey soared within days, in the case of Croatia from 100 to 450 basis points initially, and close to 600 points in early March 2009 (Graph 3, right-hand panel).[3]

The turmoil in October quickly spread to the **foreign exchange markets**. The collapse of Icelandic banks led to a dramatic drop in the equity price of Hungary's OTP bank (which was viewed as vulnerable because it is not majority foreign-owned) and a collapse in foreign de-

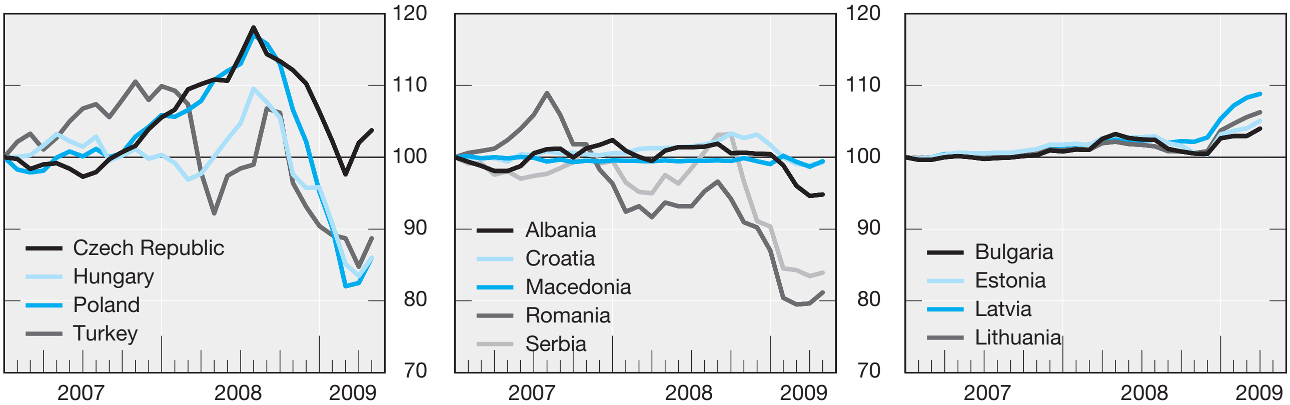
Graph 3 CDS spreads[a]



[a] *Senior five-year CDS mid spread, in euros. Five-day moving averages; in basis points.*

Source: Datastream.

Graph 4 Exchange rates[a]



[a] *December 2006 = 100; euro per unit of local currency (nominal effective exchange rates for Bulgaria, Estonia, Latvia and Lithuania). An increase indicates an appreciation; monthly averages.*

Sources: ECB; Datastream; national data; BIS.

[3] By the end of April, the Croatian CDS spreads dropped back to around 300 points, as a measure of calm returned to CEE markets. However, 300 points is still a heavy insurance premium: an investor buying $10 million worth of Croatian government bonds needs to pay $300,000 to insure against the risk of default on these bonds.

mand for forint-denominated government bonds. As banks were no longer prepared to exchange euros for forints in foreign currency swap markets, the forint depreciated sharply, triggering contagion effects throughout the region (Graph 4).[4] The Polish zloty, for instance, depreciated by over 20% against the euro over the fourth quarter of 2008 (left-hand panel).

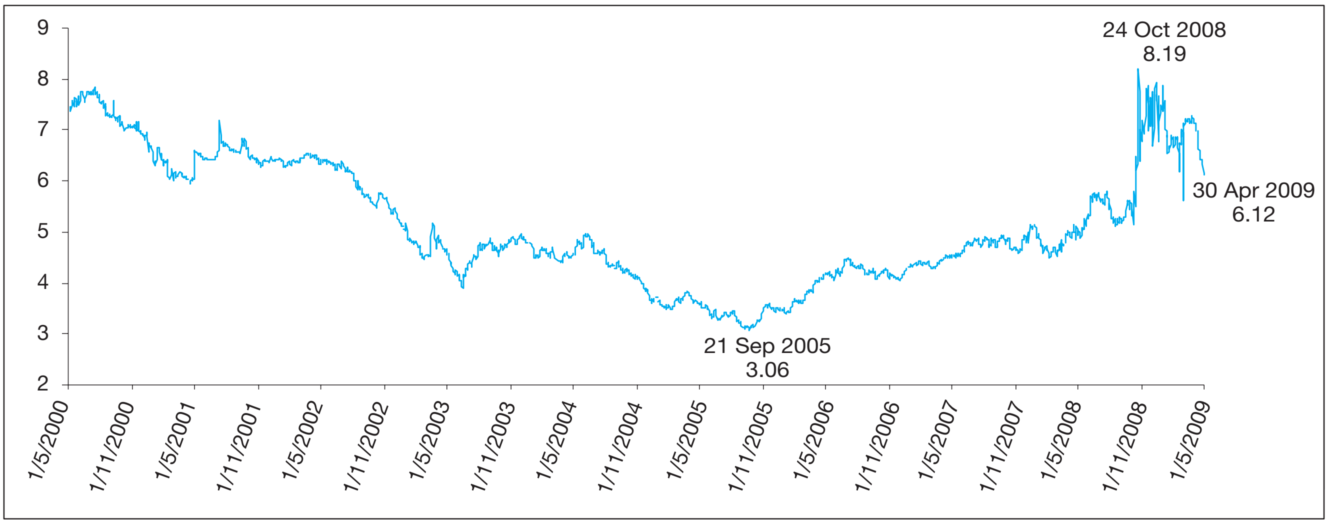
Household and corporate borrowers with large foreign exchange exposures suffered losses as local currencies fell against the euro, the Swiss franc and the dollar. Many investors with maturing foreign currency debt were forced to raise foreign exchange by selling local currency assets at much depreciated prices, magnifying the decline in exchange rates and equity prices in very thin markets. Liquidity was drained from the interbank markets as well, with money market rates spiking occasionally at 40% in Croatia and Romania.

Several central banks responded by lending euros to their banks. The ECB provided euro refinancing (against high-quality collateral) to Hungary and Poland, and the Swiss National Bank extended Swiss franc/euro swap arrangements to Hungary and Poland. The Croatian National Bank intervened directly in the foreign exchange market and released foreign exchange liquidity by repealing the marginal and lowering the minimum reserve requirement on foreign borrowing by banks. As a result, the kuna depreciated vis-à-vis the euro by only about 4% between end-September 2008 and end-January 2009.

The latest storm that hit the CEE markets started on 17 February, when the rating agency Moody's (2009) warned that it might downgrade banks active in CEE because of their heavy exposure to the region. Although the report revealed no new information about the vulnerabilities of parent banks or their subsidiaries, it shook investor confidence. Equity prices plunged by more than 10% on average within a week (Graph 1); bond spreads soared to 300 basis points in Poland and 500 points in Croatia and Hungary (Graph 2); currencies came under renewed pressure (Graph 4); and parent banks' CDS spreads rose sharply. Taken together, these developments have led to widespread concerns about the imminent onset of a financial crisis in the region.

As it turned out, the Moody's report and the subsequent reporting in the press (especially the *Financial Times* and the *Economist*) contained errors that may have influenced market decisions. In particular, figures on foreign bank lending were misreported by including not only cross-border loans from parent banks to their subsidiaries in CEE, but also loans that the subsidiaries granted on the basis of deposits in domestic and foreign currencies raised from their local customers in CEE. This prompted central banks of the Czech Republic, Hungary, Poland and Romania to coordinate the issuance of press statements informing the markets about the actual state of foreign bank lending in their countries.[5] On 23 February, the rating agency Standard and Poor's (2009) issued a report that introduced somewhat greater differ-

Graph 5 Yield of Croatian Government eurobonds (Euro EMBI Global HR) in percentage points



Source: JP Morgan.

[4] In foreign currency swap markets two parties, usually banks, exchange surplus foreign currencies for a certain length of time, at fixed or floating interest rates, and agree to reverse the transaction at a later date.

[5] See eg. http://www.cnb.cz/en/public/media_service/press_releases_cnb/2009/090224_statement_FT.html

entiation among the countries in the region. Around the same time, the Austrian National Bank clarified several key arguments behind its pan-European initiative launched in late January, which was aimed at assisting the CEE countries to avoid a crisis (OeNB, 2009).

In summary, financial markets in CEE and Croatia have been hit very hard by the global financial crisis. Countries with large current account deficits and large currency or maturity mismatches in their private sector balance sheets are experiencing significant pressure on their currencies and sharply higher cost of external finance. In Croatia, the risk premium on external borrowing for the government (measured by the index of widely traded emerging market bonds Euro EMBI Global) increased roughly five times since the middle of 2008, and 20 times since the middle of 2007 (Graph 2). The cost of external borrowing, measured by the yield on sovereign bonds (i.e. the rate of return that market investors require to hold Croatian government debt) increased from 3% in September 2005 to 6% in April 2009 (Graph 5). Together with fears of the impact on their banking systems, these concerns have already led Hungary, Latvia, Serbia, Romania, Turkey and Ukraine to seek IMF assistance. At present it is not clear whether actions taken by the CEE countries' authorities and external assistance will prevent the spread of a CEE-specific turmoil on top of the global crisis.

3 Capital flows and external balances

Since late 2008, the financial crisis has also spread to the **real economy**. The April 2009 consensus forecast for central and eastern Europe indicates that GDP in the region as a whole is expected to decline by -3.2% in 2009, and in Croatia by -2.9% (Consensus Economics, 2009). By comparison, in December 2008 the consensus forecast for growth in Croatia in 2009 was 1.8%. The deterioration in the real sector that is currently underway will no doubt deepen in the coming months and have severe second-round effects on banks. This will be another serious test for financial stability in Croatia as well as CEE.

In addition to the sharp fall in external demand and output, prospects for a sharp and disruptive fall in the availability of capital flows resurfaced in February 2009 as one of the main risks to the region's economic outlook. The growth of **international bank credit** to CEE initially held up remarkably well: in the first half of 2008, when loans to other emerging markets had already started to contract, the external loans of BIS reporting banks vis-à-vis the non-bank private sector in CEE were equivalent to 75% of the total for 2007 (55% in the case of loans to the banks) (Appendix Tables A1 and A2).[6]

But during the third quarter of 2008, the BIS reporting banks withdrew loans from banks in all CEE countries with the exception of Bulgaria, Lithuania and Turkey (Appendix Table A1). Similarly, there was a net outflow to the BIS reporting banks from the non-bank private sector in all CEE countries with the exception of Hungary, Romania, Serbia and Slovakia (Appendix Table A2). The reversal was not restricted to the countries with large current account deficits and significant currency or maturity mismatches in their balance sheets. Some of the largest outflows took place from banks in the Czech Republic, Poland and Slovakia, suggesting that some parent banks may have resorted to internal borrowings from their CEE affiliates in an effort to deleverage and to liquefy their balance sheets.

In Croatia, central bank's prudential measures managed to restrict the growth of cross-border loans to banks almost completely in 2007 (Appendix Table A1), but corporations resorted to direct borrowing from abroad, increasing their external debt by \$6.6 billion (Appendix Table A2). In the first quarter of 2008, gross external loans surged both to banks (by \$2 billion) and to the non-bank private sector (by \$2.3 billion). However, cross-border loans to banks started to reverse already in the second quarter and the outflow accelerated in the third quarter (by \$2.5 billion). Cross-border loans to the non-bank private sector were still positive in the second quarter but reversed as well in the third quarter. Surprisingly, in the fourth quarter of 2008 cross-border loans to banks in Croatia increases by \$2 billion, and to non-banks by \$0.4 billion. Croatia was similar in this respect to other smaller economies in the region. By contrast, in larger CEE economies such as the Czech Republic, Poland, Russia and Turkey, cross-border loans decreased significantly in the fourth quarter. However, data for the first quarter of 2009 will probably indicate a decrease in cross-border loans in Croatia and other smaller CEE economies because of the deepening of the crisis.[7]

Data on **international bond issuance** and syndicated loans depict the same picture. After record-high issuance

[6] Bank for International Settlements (BIS) collects and disseminates since 1964 data on international banking transactions. Quarterly reports on transactions are submitted by banks from 41 advanced economies, and they cover over 90% of total international banking transactions. For more information see www.bis.org/statistics.

[7] The BIS international banking data for Q4 2008 were released at the end of April 2009; data for Q1 2009 will be released in early July 2009.

of international debt securities in 2007 and the first half of 2008 (a total of $15 billion and $10 billion, respectively), net bond issuance in CEE fell in the second half of 2008 to just $0.3 billion. In the first quarter of 2009 net international bond issuance increased slightly due to successful placements of sovereign bonds by Poland and Turkey, albeit at much higher spreads than a year ago. Croatia made net repayments of maturing debt in both 2008 and in the firts quarter of 2009 (by $1 billion and $0.7 billion, respectively).

Syndicated lending to the region slowed already in the first half of 2008, to $17 billion (from $39 billion in 2007), and fell further in the second half of the year (to $12 billion). In the first quarter of 2009, syndicated lending in CEE amounted to less than $3 billion, with Croatia accounting for $0.7 billion.

Compared with cross-border loans and debt flows, foreign direct investment flows are estimated to have held up relatively well last year. However, most of the inflows took place during the first half of the year. Recent data releases indicate that the inflows decelerated sharply in the third quarter. For instance, net FDI inflows to Croatia for the first three quarters of 2008 were over 20% lower than in the same period of 2007. The deceleration was particularly pronounced in the third quarter of 2008, with net inflows of just $170 million, compared with $1.1 billion in the first quarter.

Meanwhile, despite indications of severe retrenchment of capital inflows, the **balance of payments** data suggest that external current account deficit of Croatia increased from -7.6% of GDP in 2007 to -9.4% in 2008. Projections of the deficit – and, hence, of external borrowing requirements – for 2009 are highly uncertain at present because it is extremely difficult to estimate how deep and prolonged the downturn in external demand will be. An additional uncertainty is the extent of the downturn in household incomes and employment in the EU countries that traditionally provide most of the tourists to Croatia. In any event, one can be fairly certain that the current account deficit will decline this year because more restricted and costlier external finance will lead to a decline in imports of goods and services. For instance, in its April *Quarterly Outlook*, the Economics Institute Zagreb (2009c) projects a decrease in the current account deficit to -4.7% of GDP.

This deficit could still be difficult to finance in the current circumstances. For instance, the external funding constraints forced Estonia to cut its current account deficit from close to 17% of GDP in the last quarter of 2007, to 6% in the last quarter of 2008. One should note in this context that Estonia has a much sounder government balance sheet than Croatia: during 2001-2008, the government accumulated about 10% of GDP in reserves by consistently running budget surpluses.

In summary, the reversal of large capital inflows, which have to a large extent financed the expansion in CEE and Croatia since 2002 (see Mihaljek, 2008), started during the summer of 2008 and has most likely accelerated in late 2008 and early 2009. It has affected not only countries with external and fiscal vulnerabilities such as Croatia, but also countries with sounder fundamentals such as the Czech Republic, Poland and Slovakia. The external finance has become not only more expensive but also more scarce. These conditions are not likely to improve significantly over the next couple of years – the extremely favourable conditions that prevailed in global financial markets through 2007 may not be seen again for quite a while. Besides immediate problems with rollover of maturing foreign debt in 2009, this means that the entire Croatian economy – the corporate sector, banks, households as well as the public sector – faces the challenge of adjusting to a new pattern of growth that will have to be based primarily on domestic rather than foreign sources of saving (see Čičin-Šain, 2008).

4 Macroeconomic policy mix

The past few months have been one of the most challenging periods for macroeconomic policies since the start of the transition from socialist economic systems in 1989. Despite the rapid rise in inflationary pressures through much of 2008, fiscal policy in Croatia and other CEE countries generally continued to stimulate aggregate demand, leaving the main responsibility for combating inflation to central banks. At the same time, the disruptions in international credit markets, which mutated into a full-scale global financial crisis in September 2008 and plunged the CEE markets into turmoil in February 2009, have initially forced central banks to pursue the conflicting objectives of ensuring banking system liquidity and addressing still strong inflationary pressures. Over the past two months, the policy focus has shifted again – this time in a matter of weeks – from softening the sharp fall in output toward preventing a financial meltdown.

Monetary policy: adapting quickly to changing circumstances

Countries with inflation targeting strategies of monetary policy (the Czech Republic, Hungary, Poland, Romania, Serbia and Turkey) have generally been able to adapt more easily to changing macroeconomic circumstances than those with fixed exchange rates (Bosnia and Herzegovina, Bulgaria, Estonia, Latvia and Lithuania) or managed exchange rate regimes (Croatia and Macedonia). This is partly because inflation targeting central banks, supported by well-defined institutional frameworks, have been able to react to rising inflationary pressures by increasing short term nominal (and real) interest rates. Many of these countries consequently experienced substantial appreciation of their exchange rates through mid-2008, which in turn helped contain imported inflation.

In countries with fixed exchange rates the opportunities for raising interest rates – and the effects that such a move would have – were limited not only by exchange rate regimes but also by the high degree of currency substitution. As a result, the authorities had to deal with inflationary pressures indirectly, for instance, by trying to tackle the sources of inflation such as the rapid credit growth via prudential regulations. In Bulgaria and Croatia, central banks thus progressively tightened reserve requirements and other prudential regulations through the first half of 2008 in order to limit credit growth. More administrative measures, such as bank-by-bank credit limits, were also used in some cases (e.g. in Croatia and Montenegro).

Starting in October, the policy focus shifted from fighting inflation to providing liquidity to domestic banking systems. The collapse of Lehman Brothers affected many parent banks with operations in CEE, forcing them to deleverage and liquefy their assets. As discussed in Section 2, this had major repercussions for market liquidity in CEE, especially in those countries that are financially closely integrated with western Europe. As oil prices dropped sharply at the same time, removing one of the main threats to inflation, the inflation targeting central banks responded by cutting interest rates in a rapid succession of moves.

In countries with fixed or tightly managed exchange rates, the policy response depended on the spillovers from the global markets on the domestic banking systems. Where banking sector stability was at risk, this became a priority for monetary policy. For instance, banks in Bosnia and Herzegovina, Montenegro and Serbia (and to a lesser extent Croatia) were adversely affected by a substantial withdrawal of foreign currency deposits during the autumn of 2008. The central banks in these countries responded by lowering reserve requirements (in particular on foreign borrowing) to provide liquidity to the banks, and, together with the fiscal authorities, by increasing deposit insurance limits.

Where stability of the banking system was not an immediate concern (e.g. in Bulgaria, Croatia and Lithuania), central banks expanded repo operations, lowered the reserve requirements or loosened various prudential regulations on bank lending. The Croatian National

Table 1 Selected fiscal indicators, 2007-2009[a] (as a percentage of GDP)

	General government balance			Budget structure, 2008		Public debt, 2008[b]
	2007	2008	2009	Revenue	Expenditure	
Czech Republic	-0.6	-1.5	-4.3	40.9	42.4	29.8
Hungary	-4.9	-3.4	-3.4	46.5	49.9	73.0
Poland	-1.9	-3.9	-6.6	39.2	43.1	47.1
Slovakia	-1.9	-2.2	-4.7	32.7	34.9	27.6
Slovenia	0.5	-0.9	-5.5	42.7	43.6	22.8
Estonia	2.7	-3.0	-3.0	37.9	40.9	4.8
Latvia	-0.4	-4.0	-11.1	35.5	39.5	19.5
Lithuania	-1.0	-3.2	-5.4	34.0	37.2	15.6
Bulgaria	0.1	1.5	-0.5	38.9	37.4	14.1
Croatia	**-1.6**	**-1.3**	**-1.4**	**45.0**	**46.3**	**35.6**
Romania	-2.5	-5.4	-5.1	33.1	38.5	15.2
Turkey	-1.0	-2.1	-4.6	21.4	23.5	39.5
Albania	-3.8	-5.2	-3.9	27.5	32.7	52.6
Bosnia and Herzegovina	-0.1	-1.9	-3.1	47.8	49.7	34.3
Macedonia	0.6	-1.0	-3.5	35.6	36.6	21.4
Montenegro	6.4	1.5	-6.2	44.4	42.9	32.3
Serbia	-1.9	-2.3	-1.8	42.0	45.2	33.8
Average	**-0.7**	**-2.3**	**-4.3**	**38.0**	**40.3**	**30.4**
Euro area	-0.6	-1.9	-5.3	44.7	46.6	69.3

[a] Official estimates and projections. For Croatia, EIZG (2009b; 2009c). [b]Gross debt on a general government basis.

Sources: European Commission, Spring 2009 Forecast, May 2009; IMF country reports; national data.

Bank, for instance, abolished the marginal reserve requirement on banks' foreign borrowing in October in order to boost commercial banks' liquidity; in November, it also reduced the reserve requirement rate by 3 percentage points in order to provide additional liquidity.

In view of the sharp deterioration of the real sector outlook, as late as mid-February most market analysts expected central banks to continue with rate cuts and other measures aimed at improving liquidity. However, market turmoil unleashed by the Moody's downgrade warning to parent banks with operations in CEE once again shifted the policy focus in several countries, this time to stabilising the exchange rates and preventing the onset of a full-blown financial crisis. The Czech National Bank announced a likely interest rate hike to prevent further slide of the koruna, and the Polish authorities, which have not intervened in foreign exchange markets for over a decade, sold some of the funds that Poland receives from the EU in order to boost the falling zloty. More governments announced the start or intensification of talks with the IMF on emergency loans, and central banks and governments in several other countries called for co-ordinated EU approach to help stabilise CEE markets.

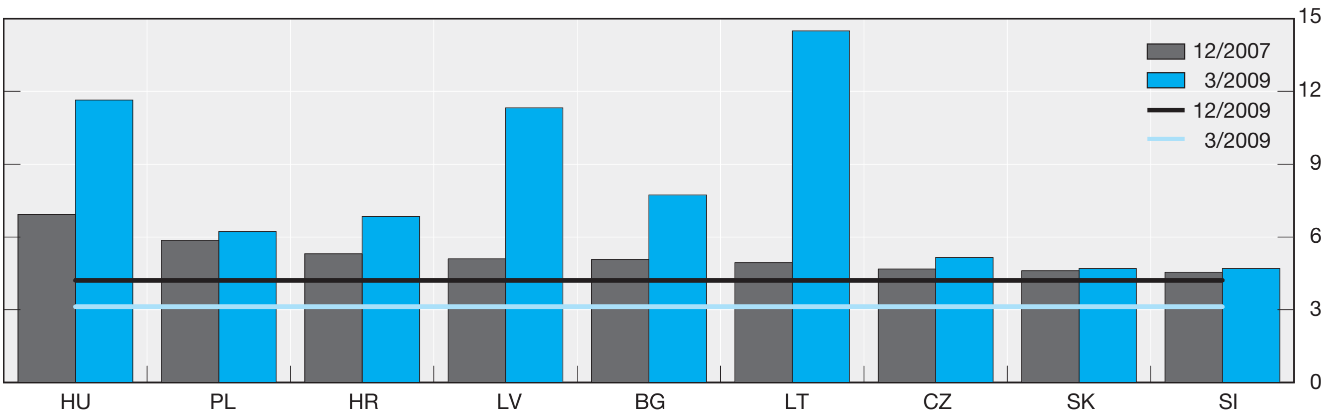
Fiscal policy: providing insufficient support to macroeconomic stabilisation

Like monetary policy, fiscal policy had to deal with several rapidly moving targets over the past year. During the first half of 2008, when inflation was the main concern, fiscal policy in most CEE countries, including Croatia, responded with greater spending instead of more restrictive measures (see Section 1). This was apparently done in the belief that the rise in inflation would be temporary, and would not affect wage expectations. Inflation expectations, however, continued to rise.

In the autumn of 2008, the focus of fiscal measures shifted toward ensuring banking stability through an increase in guarantees on bank deposits. The end result was that fiscal performance deteriorated in almost all CEE countries in 2008 (Table 1). Only Hungary and Bulgaria improved their fiscal positions substantially last year. While Croatia reduced its fiscal deficit marginally last year, one should note that it still has one of the highest revenue and expenditure shares in the region (45% and 46% of GDP, respectively), comparable only to those of Hungary, Bosnia and Herzegovina and Montenegro.

Further challenges arose in late 2008 and early 2009 amid growing demands for fiscal stimulus packages. As noted above, partly in response to the packages announced by western European governments, some opposition politicians and special interest groups have argued that the Croatian authorities should put in place their own programmes of assistance for selected sectors of the economy or for public infrastructure development. Other CEE countries have not been immune to such demands, either. According to the latest European Commission (2009) forecast, budget deficits will increase in 2009 by 2% of GDP on average, and by up to 7-8% in Latvia and Montenegro (Table 1). In the Czech Republic, Poland, Slovakia and Slovenia budget deficits will increase by 2½-4½% GDP, partly as a result of the planned expansion in public spending. Possible fiscal policy responses to the latest bout of instability that swept through financial markets in February 2009 have yet to be announced.

Graph 6 Long term interest rates[a]



BG = Bulgaria; CZ = Czech Republic; HR = Croatia; HU = Hungary; LT = Lithuania; LV = Latvia; PL = Poland; SI = Slovenia; SK = Slovakia.

[a] *Long-term domestic currency government bonds; the horizontal line refers to the 10-year German benchmark bond; end-of-period observations; in percentage.*

Sources: Datastream; ECB; national data.

How the higher budget deficits in the region will be financed remains unclear. The high degree of uncertainty about the ability of governments in CEE to secure funding is partly reflected in the sharp increase in long-term interest rates and market prices for protecting against defaults (i.e. CDS spreads) (Graph 6). Not surprisingly, long-term rates have increased particularly sharply for the Baltic states, Bulgaria, Croatia and Hungary, the »usual suspects« when it comes to external vulnerabilities in the region. It is also unsurprising that sovereign credit ratings of the Baltic states and Hungary (as well as those of Croatia, for domestic currency debt) have been lowered since October 2008.

In summary, fiscal policy in Croatia, as well as elsewhere in the region, has provided only limited support to monetary policy in the current challenging environment. In the period ahead, fiscal policy should provide support to monetary policy by focusing on consolidation rather than expansion. The scope to stimulate the economy through fiscal expansion in countries such as Croatia is limited first and foremost by foreign and domestic investors' perception about CEE countries' fiscal solvency. This perception has taken a severe hit in the latest round of crisis, and is not likely to recover soon. But, as discussed in the next section, even in the absence of financing constraints fiscal expansion is associated with some major implementation risks.

What are the risks from fiscal expansion?

In the face of the deepest recession in decades, with monetary policy reaching the limits of feasible, governments of many large countries started to launch fiscal stimulus packages to boost output and fight rising unemployment. The fiscal stimulus in Europe is estimated at almost 3% of GDP this year (Saha and von Weizsäcker, 2009). IMF (2008) expects that the tax cuts and increased spending in 2009 will cost around 1.5% GDP globally.

The fiscal expansion represents a significant departure from the former broad consensus against discretionary fiscal policies. According to this view, fiscal policy should support the economy during a slowdown solely through the operation of automatic stabilisers, provided that the underlying fiscal position was sound. During a slowdown the fiscal deficit would rise automatically due to decreasing tax revenues and rising social security transfers. The scale and strength of automatic stabilisers varies between countries and depends primarily on the progressivity of the tax system and responsiveness of social security benefits to GDP growth. According to OECD (2008), the cyclical component of the budget deficit – i.e. non-discretionary fluctuations of revenue and expenditure over the business cycle – for euro area countries would increase by about 1% of GDP in 2009. Automatic stabilisers should therefore provide an important contribution to sustaining aggregate demand in the economy. But at the same time, they will result in a severe deterioration of fiscal positions of euro area countries.

The consensus view also held that the use of large-scale discretionary fiscal stimuli should be confined only to exceptionally severe recessions. The current crisis no doubt meets this definition: the channels of monetary policy transmission have become ineffective in many countries, so there seems to be a need for another tool to boost output and protect against even deeper and longer recession. However, governments considering fiscal expansion should bear in mind the possible short-term and long-term risks of such measures.

Sustainability risks. With any fiscal expansion, there is a potential threat to long-term sustainability of public finances. A lot depends on the initial state of public finances and sustainability concerns present before the onset of the crisis. In many European countries, including Croatia, such concerns are clearly relevant, given the history of high budget deficits and high public debt. Operations conducted by many governments to rescue troubled financial institutions will also increase the stock of public debt. Finally, a major fiscal sustainability constraint is the impact of the ageing of the population on pensions and healthcare spending.

The current crisis has revealed that the fiscal sustainability outlook of many countries is much worse than previously thought. Countries that have enjoyed very strong growth and fiscal surpluses in recent years, such as Ireland, Spain and Latvia, are now experiencing very severe recessions, leading to a dramatic reassessment of their growth prospects and, as a result, their fiscal sustainability. For instance, Spain's AAA long-term sovereign debt rating was lowered by S&P to AA+ in January 2009. For Latvia, the rating was already downgraded three times between October 2008 and February 2009. One common feature of these countries and Croatia is that their economic expansion and growth of budget revenues have relied to a great extent on construction and real estate sectors, which are currently experiencing a severe downturn. Past experience suggests that downturns in the construction sector tend to be protracted and severe: following the building boom spurred by reunification in the early 1990s, output and employment in the German construction sector were declining for ten years (between 1994 and 2004), with both contracting by a cumulative of 30% (BIS, 2006).

The reassessment of countries' solvency by financial markets is an inevitable by-product of the current increase in risk aversion and the »flight to safety« by global investors. In the current uncertain environment, investors are shifting to bonds issued by the most credible issuers. This move is being facilitated by the significant increase in bond issuance by AAA rated governments, such as the United States, the United Kingdom, France and Germany. As a result, spreads on government bonds and credit defaults swaps of euro area countries such as Greece and Ireland, whose fiscal positions are considered particularly fragile, as well as CEE countries, have risen sharply. Concerns expressed by the markets in the latter case also include large external imbalances, large-scale foreign borrowing by the private sector, and the widespread use of foreign-currency housing loans. In these circumstances, an additional fiscal stimulus could be perceived by the markets as an irresponsible policy, and lead to a vicious circle of further currency depreciation leading to defaults on foreign currency borrowing and eventually resulting in a banking crisis.

Effectiveness of fiscal stimulus plans. The effectiveness of discretionary fiscal policy actions depends on the way the stimulus package is designed and announced to the public. Incoherent and unclear plans may lead to uncertainty among private agents, so the end effect may be detrimental rather than supportive to economic activity. In addition, discretionary fiscal actions usually take considerable time to get implemented, especially in the case of infrastructure projects. The stimulus might thus start at a time when the economy has already recovered, adding to the boom and risks of overheating.

The initial condition of public finances and the way the future costs of the stimulus are perceived by consumers and investors have a strong influence on the effectiveness of the fiscal package. Private agents often rationally expect a tightening of fiscal policy after the recession, knowing that the government will have to repay the accumulated debt and will either have to increase taxes or reduce public spending. Germany again provides a good example: after the fiscal expansion of the 1990s, which financed reunification, German households reduced their consumption sharply in the early 2000s, expecting a decline in future pension and health care benefits. In other words, households may decide to save rather than spend the additional money received from a temporary boost to government spending. Empirical research shows that such behaviour, consistent with so-called Ricardian equivalence, is more likely to occur when the degree of »fiscal stress« represented by the level of government debt is relatively high.

A discretionary fiscal stimulus is also associated with a number of political risks. As a result of political pressures, stimulus funds are often channelled not to those sectors of the economy where they would provide the greatest benefit in terms of output and employment, but to the sectors such as infrastructure construction where the use of stimulus funds is highly visible by the media and hence of greatest value to the politicians, not to mention special interest groups such as the construction lobby.

To the extent that a country can finance fiscal expansion without a major increase in sustainability risk, the World Bank suggests focusing the incentives towards cushioning the impact on the poor and vulnerable segments of the population. This policy could be implemented through a temporary increase (say, over a 12-month period) in social assistance spending on child allowances, unemployment benefits and lowest pensions. These target groups have a high propensity to consume domestic goods, and would thus help support domestic production during the downturn (see World Bank, 2009).

The effectiveness of budgetary expansion in easing the recession also depends on the openness of the economy. Fiscal multipliers are usually lower in small and more open economies, where a relatively big part of the funds directed to the private agents are spent on imports rather than locally produced goods and services (IMF, 2008). Croatia seems to fit this description rather well.

Increased government borrowing in addition implies a crowding-out of the private sector from the domestic credit supply. Banks and other domestic investors often prefer to hold government bonds during recessions as a relatively safe and high-yielding asset. This in turn crowds out investment in private assets such as loans to enterprises and households.

In summary, there are several important risks that should be taken into account when considering a fiscal stimulus. The design, timing and the way the stimulus package is communicated to the markets have a crucial impact on its effectiveness. The need for discretionary fiscal action also should be assessed against the initial condition of public finances, the degree of openness of the economy, and the likely extent of crowding-out of the private sector. The risks of sustainability and effectiveness seem highly relevant for Croatia at present. Giving in to populist pressures and embarking on fiscal expansion in the current near-crisis environment would seriously undermine macroeconomic and financial stability and could push the economy deeper into crisis instead of helping it overcome the downturn.

Appendix

Table A1 Growth of external loans vis-à-vis banks in central and eastern Europe[a]

	Changes in gross amounts outstanding at end-period								
	in million USD						in % GDP		
	2006	2007	Q1 08	Q2 08	Q3 08	Q4 08	2006	2007	2008
Czech Republic	1,631	5,966	3,872	338	-2,659	-3,094	1.1	3.4	-0.7
Hungary	5,142	7,425	4,763	3,301	-2,575	3,904	4.5	5.4	6.0
Poland	5,216	20,807	15,317	5,078	-4,768	-5,551	1.5	4.9	1.9
Slovakia	-2,817	5,393	510	2,518	-1,267	572	-5.0	7.2	2.4
Slovenia	4,021	6,453	2,659	1,507	-2,293	-1,283	10.3	13.7	1.1
Estonia	2,093	4,873	1,644	385	-1,080	178	12.7	23.3	4.9
Latvia	4,972	6,227	2,516	429	-716	-379	24.9	21.6	5.4
Lithuania	3,242	5,423	697	1,141	458	278	10.8	13.9	5.4
Bulgaria	420	3,616	1,106	2,731	992	-369	1.3	9.1	8.6
Croatia	2,798	65	2,010	-620	-2,539	2,075	5.7	0.1	1.3
Romania	4,872	17,053	4,061	3,823	-538	500	4.0	10.1	3.9
Turkey	4,832	4,169	8,268	-4,404	7,037	-7,138	0.9	0.6	0.5
Albania	-380	165	-121	-27	-25	-1	-4.2	1.5	-1.3
Bosnia and Herzegovina	442	844	180	407	-443	184	3.6	5.6	1.8
Macedonia	1	40	-10	6	-15	-39	0.0	0.5	-0.6
Serbia	2,486	-672	-43	112	-55	684	8.4	-1.7	1.4
Montenegro	53	528	108	114	19	19	2.0	13.7	5.4

[a] *External loans of BIS reporting banks.*

Sources: BIS; IMF.

Table A2 Growth of external loans vis-à-vis the non-bank sector in central and eastern Europe[a]

	Changes in gross amounts outstanding at end-period								
	in million USD						in % GDP		
	2006	2007	Q1 08	Q2 08	Q3 08	Q4 08	2006	2007	2008
Czech Republic	3,465	3,514	2,325	1,076	-1,939	-72	2.4	2.0	0.6
Hungary	1,284	7,087	3,624	5,292	438	-622	1.1	5.1	5.6
Poland	6,242	6,432	4,405	1,960	-1,880	-1,573	1.8	1.5	0.6
Slovakia	915	2,391	1,053	267	801	-79	1.6	3.2	2.1
Slovenia	1,108	2,984	892	619	-540	592	2.8	6.3	2.9
Estonia	1,292	574	188	69	-364	-179	7.9	2.7	-1.2
Latvia	668	2,532	394	233	-368	-40	3.4	8.8	0.6
Lithuania	1,448	1,543	934	691	-703	-143	4.8	4.0	1.6
Bulgaria	2,786	2,188	1,600	1,147	-360	577	8.8	5.5	5.7
Croatia	2,794	6,569	2,293	1,439	-480	358	5.7	11.2	5.2
Romania	4,354	7,096	3,275	2,071	291	996	3.5	4.2	3.3
Turkey	16,229	22,058	7,306	6,842	192	-3,460	3.1	3.4	1.5
Albania	-462	-19	16	191	22	296	-5.1	-0.2	4.0
Bosnia and Herzegovina	-39	348	164	111	-62	-30	-0.3	2.3	1.0
Macedonia	37	98	61	27	35	21	0.6	1.2	1.5
Serbia	2,016	3,427	781	-193	120	-395	6.8	8.5	0.6
Montenegro	104	222	50	154	-2	16	3.9	5.8	4.5

[a] *External loans of BIS reporting banks.*

Sources: BIS; IMF.

Literature

Bajo, A., 2008. » The 2008 state budget: social peace and public sector expansion« [online]. *IPF Press release,* 1, (1), 1-8. *Zagreb:* Institute of Public Finance. Available from: [http://www.ijf.hr/eng/releases/1.pdf].

BIS, 2006. »Residential investment and housing markets« in: 76th *Annual Report*, 2005/06, Chapter 2. Basel: Bank for International Settlements. Available from: [www.bis.org].

Consensus Economics, 2009. *Eastern Europe Consensus Forecasts.* London: Consensus Economics.

Čičin-Šain, A., 2008. »Nakon financijske, velika gospodarska kriza«. *Jutarnji list*, November 29.

EIZG, 2008. *Croatian Economic Outlook Quarterly*, No. 36. Available from: [http://www.eizg.hr/AdminLite/FCKeditor/UserFiles/File/CEO36-October08.pdf].

EIZG, 2009a. *Mjere za ublažavanje posljedica gospodarske krize*. Zagreb: Ekonomski institut Zagreb. Available from: [http://www.eizg.hr/Item.aspx?Id=488&lang=1].

EIZG, 2009b. *Croatian Economic Outlook Quarterly*, No. 37. Available from: [http://www.eizg.hr/AdminLite/FCKeditor/UserFiles/File/CEO37-January09.pdf].

EIZG, 2009c. *Croatian Economic Outlook Quarterly*, No. 38. Available from: [http://www.eizg.hr/AdminLite/FCKeditor/UserFiles/File/CEO38-April09.pdf].

Gatarić, Lj., 2008. »Šukerov paket mjera: kritika ekonomista«. *Večernji list*, March 25.

IMF, 2008. »Fiscal policy as countercyclical tool«. *World Economic Outlook*, Chapter 5 October. Washington: International Monetary Fund.

Mihaljek, D., 2008. »The financial stability implications of increased capital flows for emerging market economies«. *BIS Papers,* (44), 11-44.

Moody's Investors Service, 2009. *West European ownership of east European banks during financial and macroeconomic stress* [online]. Available from: [www.moodys.com].

OECD, 2008. *Economic Outlook,* No. 84. Paris: OECD.

OeNB, 2009. »Facts and figures on economic developments and the financial sector in an increasingly integrated Europe« [online]. Wienna: Austrian National Bank, March 9.

Ott, K., 2008. »Da se smrzneš« [online]. *Banka*, December.

Ott, K., 2009. »Fiscal destimulation instead of fiscal stimulation« [online]. *IPF Press release,* 2 (9), 1-2. Zagreb: Institute of Public Finance. Available from: [http://www.ijf.hr/eng/releases/9.pdf].

Pavić, A., 2008. »Stručnjaci: glavni cilj u ovoj godini je borba s rastućom inflacijom« [online]. *Poslovni dnevnik*, March 14. Available from: [http://www.poslovni.hr/73651.aspx].

Saha, D. and Weizsäcker, J. von., 2009. »Estimating the size of the European stimulus packages for 2009: an update«. Bruegel Note, February 20.

Standard and Poor's, 2009. *Market dislocation exposes vulnerability of eastern European economies* [online]. February 23. Available from: [www.standardandpoors.com].

Šajatović, M., 2008. »Štednja u proračunu za 2009. pogrešna mjera u pogrešno vrijeme«. *Lider*, October 16.

Varošanec, S., 2008. »Ekonomisti nude recept rasta od 7%«. *Poslovni dnevnik*, February 8.

World Bank, 2009. *Russian economic report,* No. 18. Available from: [www.worldbank.org.ru].

Institut za javne financije
Smičiklasova 21
Zagreb, Hrvatska
p.p. 320

INSTITUT ZA JAVNE FINANCIJE

Institute of Public Finance
Smičiklasova 21
Zagreb, Croatia
PO Box 320

TISKANICA