PowerPoint for Presentation at the Conference "Toward a More Integrated and Stable Europe"

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- I. Some Background
- 1. The CESEE consists of a number of not particularly homogeneous countries. Their unifying features are largely two: they are located in the eastern part of Europe; and almost all are countries that used to be “economies in transition”

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- 2. Most had transited to become "market economies", before the financial crisis struck. However, they had been trying to find their place between the "welfare states" of Europe and the more "market-oriented" Anglo-Saxon countries.These differences were reflected in the shares of public spending into GDPs.

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- 3. My remarks will be based on 13 of these countries. They include the larger ones of Poland, Russia, Turkey, and Ukraine.

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- Before the financial crisis arrived, the levels of general government's ordinary revenues for these countries ranged from a little over 30 percent of GDP (in Turkey, Romania, and the Slovak Republic) to over 40 percent of GDP (in Hungary, Ukraine, the Czech Republic, and Poland).

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- There were large differences, among these countries, in the levels of general government expenditures, as shares of GDP. In 2006, before the crisis, these levels were still relatively low (around 32-33) for Russia, Turkey, Romania and Lithuania, and high (44 and above) for Hungary, Ukraine, Czech Republic and Poland. This range reflected different choices by the countries on the role of the state in the economy.

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- The share of public spending into GDP in these countries goes from a level that I would consider desirable, and more easily sustainable (if not explicitly optimal) over the long run, to one that is high, potentially damaging to good economic performance, and, perhaps, even unsustainable <u>over the long run.</u>

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- As shares of GDP, government revenues seem to have been less affected by the recent crisis than could have been expected. The largest drops in these shares were experienced by Bulgaria, Croatia, Russia and Poland. The revenue levels (as shares of GDP) went even up in some countries, and especially in Estonia.

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- As compared with revenue, general government expenditure changed much more in most countries. It increased significantly in Estonia, Latvia, Lithuania, Romania, Russia and the Slovak Republic.

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- An interesting reaction was that of Estonia. It had the largest increase in general government expenditure (as a share of GDP), 13 percent between 2006 and 2009, but financed a large part of that increase, about 8 percent of GDP, with an increase in government revenue. This policy must have created a powerful multiplier effect.

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- By 2009-2010, six countries had expenditure levels of around or over 45 percent of GDP. Nine had levels above 40 percent of GDP. Turkey was the only country with an expenditure level still significantly below 40 percent of GDP.
- If they are not reduced, these levels could create significant macroeconomic or even efficiency problems in future years. However, their reduction would require major and difficult reforms.

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- Data on general government balances indicate that, in 2007, before the crisis, three countries, Bulgaria, Estonia, and Russia, had significant budget surpluses, that gave them some fiscal space during the crisis. However, several countries had already significant fiscal deficits, especially Hungary and Romania.

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- By 2009 <u>all</u> of these countries had deficits, ranging from a low level of 0.9 percent of GDP, in Bulgaria, to levels that exceeded 5 percent of GDP in the Czech Rep., Latvia, Lithuania, Poland, Romania, Russia, the Slovak Republic, Turkey, and Ukraine. The largest fiscal deterioration, between 2006 and 2009, took place in Russia (14.6 percent of GDP), Lithuania (8.8 percent of GDP), Latvia (7.3 percent of GDP), and Romania (about 6 percent of GDP).

- By 2009 all the 13 countries had negative primary balance, ranging from 0.3 for Hungary and 1 percent for Turkey to 8.1 percent for Lithuania. In six countries the negative primary balances exceeded six percent of GDP. The fiscal situation had deteriorated significantly.

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- Given the above results, and the growth performance, it was inevitable that the <u>gross debt</u> of the general government would experience a significant growth, from the generally low levels that (with the exception of Hungary) had prevailed before the crisis. In 2007 only four countries (including Hungary and Poland) had had debt to GDP ratio of more than 30 percent, Poland just over that level. By 2010 the number had growth to ten.

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- The most significant increases in the share of general governments' gross debt into GDP were experienced by Latvia, Lithuania, Romania, and Ukraine, over 20 percent of GDP. Still, with the exception of Hungary, all the countries would have met the 60 percent Stability and Growth Pact criterion for public debt.

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- Before closing this descriptive part, some comments can be made with respect to the structure of tax revenue in the CESEE countries. For several important countries for which the information is available, it appears that the personal income tax and the property tax generate much less revenue than the average in OECD countries. The corporate income tax generates broadly similar levels. However, social security taxes are much more important than in OECD countries. This may help explain why the fall in public revenue was contained during the crisis.

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- II. Comments on Countercyclical Fiscal Policy
- Budgetary policy to counter the effect of the "great recession" has been the subject of great debate in recent years. Some still argue for maintaining, for the time being, a relaxed fiscal stance to sustain demand. Others, worry about fiscal sustainability and call for fiscal restraint, in spite of the continuing high unemployment. I shall make some very personal and inevitably controversial comments on this debate.

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- It is important to consider two factors: first, whether the fiscal situation of the countries before the crisis had been prudent and easily sustainable; second, whether the crisis was a traditional, Keynesian recession. That is, whether the crisis was due to the bursting of bubbles; or to the traditional weakening of animal spirits, or to increases in interest rates, that lead to under consumption and/or under investment, in an economy without significant bubbles or structural problems.

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- Given an initially prudent and sustainable fiscal situation (low deficit and low public debt), and given a traditional recession without major bubbles, fiscal policy can and should be relied upon, to help alleviate the effects of the recession. In these situations, a fiscal expansion can be expected to be helpful. This is the situation generally contemplated, implicitly by Keynesian stabilization policy.It is the textbook version of countercyclical policy.

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- However, when a crisis or a recession is the outcome of bursting bubbles (in housing, in the financial, or other sectors) we ought to look at countercyclical policy with different lenses.
- In this case:

(a) The crisis is the result of major misallocation of real resources including workers.

(b) The growth rate and the fiscal accounts have been distorted by the bubble.

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(c) It becomes very difficult to estimate potential output.

(d) Excess supply of some durable products (houses, house equipments, cars, etc.) has been produced and is likely to stay around for sometime.

(d) The workers who had been producing that excess output will also be in excess supply (unemployed) for some time.

(e) Given their skills, workers will be less fungible than assumed by Keynesian theory.

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- The consequences are that:

(a) The potency of fiscal expansion will be much reduced.

(b) Countries are likely to perform at less than trend or potential output for a long time.

(c) Unemployment will remain high much longer than expected.

(d) Maintaining large fiscal deficits will not help. It may create damage, by raising questions about fiscal sustainability or fiscal crises.

(e) If countries continue to pursue countercyclical policy, public debt will accumulate and is likely to create psychological resistance to invest and to spend.

(f) Major future problems will be created.

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- When a recession is due to bursting bubbles, the role of fiscal policy should change, from its traditional role of maintaining aggregate demand to protecting the <u>most vulnerable</u> citizens through <u>temporary</u> assistance.This is a very different role.

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- This implies that it may not be wise policy to wait until the situation returns to “normal” before beginning fiscal retrenchment.
- The “new normal” may, for a long period, be one with less production and higher unemployment.
- Fiscal deficits may not accelerate the return to the status quo ante.

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- The theory of countercyclical fiscal policy suffers from several real life weaknesses that are often ignored by economists. These are:

(a) political asymmetry

(b) bureaucratic asymmetry

(c) citizens asymmetry, and

(d) the nature of cycles.

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- Each of the above will tend to smooth the way for expansionary fiscal policy but will put obstacles on contractionary fiscal policy.
- The result of expansionary fiscal policy will be fiscal deterioration and potential fiscal crises.

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- The return to sustainable fiscal policy (exit strategy) can be expected to face resistance:

(a) at the political level;

(b) at the civil servants' level, if, as is often the case, they have benefited from the previous fiscal policy;

(c) at the citizens' level when (especially powerful) vested interests and "sacred cows" are affected;

(d) Possibly at the international level; and also

(e) by academics who have assimilated too well the Keynesian religion.

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- At the citizens' level the resistance may come from,

(a) powerful vested interests and from sacred cows that cannot be touched;

(b) from possible citizens' actions in the streets;

(c) from taxpayers resistance.

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III. Some General Guidelines: The General Commandments of Exit Strategies

- There is less virtue to fiscal deficits than is generally assumed. Give more credit to Cicero (balanced budgets) and less to Keynes.
- Fiscal retrenchment should always be accompanied by well though-out structural changes. The latter may help neutralize the potential deflationary impact of the fiscal retrenchment.

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- Keep public spending below, say, 35 percent of GDP. Higher levels do not seem to increase welfare.
- Consider the use of some "fiscal rules" that can help achieve, or maintain, the desirable fiscal situations.
- Do not allow public debt to grow much above a relatively low level, say 40 percent of GDP.

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- In exit strategy, favor expenditure cuts over tax increases.
- In cutting expenditures, do not protect "categories" (investment, education, etc.) but protect "efficient expenditures' within categories.
- There are inefficiencies in any category of public spending including investment.

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- Worry about "red tapes" and bureaucratic obstacles. They often become the cholesterol of the economic system.
- Complexity is often a problem.Try to choose simpler policies.
- Make labor market as flexible as possible.It can be in part a substitute for the welfare state.