Editorial: A case for sound public finances

Due to the current recession, fiscal deficits in all EU countries increased significantly, in some cases even dramatically. The European Commission estimates that the Euro area aggregate fiscal deficit will reach 6.4% of GDP in this year and 6.9% in 2010; and for 2011 it expects no strong improvement. Outside the Euro area the situation is even worse.

Of course, this partly reflects the working of automatic stabilisers. Tax receipts started falling due to the economic slowdown, whereas the governments have to spend more for unemployment benefits and other social transfers. Another part of the deficits is associated with the rescue plans for the banking sector, although the full extent of these measures cannot be seen yet in the budgets. Finally, most countries passed fiscal packages to stimulate aggregate demand.

In the short run, the increase of the deficits is without alternative. It also does not mean a violation of the European Stability and Growth Pact because there is no doubt that almost all EU countries are in a deep recession. In such a situation deficits above 3% in relation to GDP will be accepted temporarily. But the questions are: What will happen the day after? Is there a convincing exit strategy?

Of course, a good deal of the deficits will vanish as soon as the economy will return to trend output. Then the automatic stabilisers will work in the opposite direction than they do now. Furthermore the stabilisation packages partly consist of temporary measures which will not have a follow-up. This is true for a large part of the banking rescue packages which have taken the form of public lending to private banks. But in many countries also measures were taken that increase the structural deficits, such as tax cuts or changes in depreciation rules. According to the European Commission, the structural deficits are more than 2 percentage point higher on average in 2009 compared to 2009. Hence, in order to reduce the deficits again, the fiscal policy stance will have to be more restrictive in the upswing to come.

Some might argue that it will be too early to start the consolidation within the next two years. The expansion should be given room to develop its full power before the governments take actions to reduce the deficits. However, the current recession provides two other lessons that should make governments somewhat more concerned about their fiscal position.

Firstly, some countries which did not reduce sufficiently their deficits in the past were not able to give a stimulus to their economies now. Secondly, in difficult times markets take the non-bailout clause in the European Treaties seriously and require higher interest rates on government bonds of states with an excessive public debt. In the end, the current recession is a case for sound public finances.

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New EU-Members: Deep recession, but improving prospects

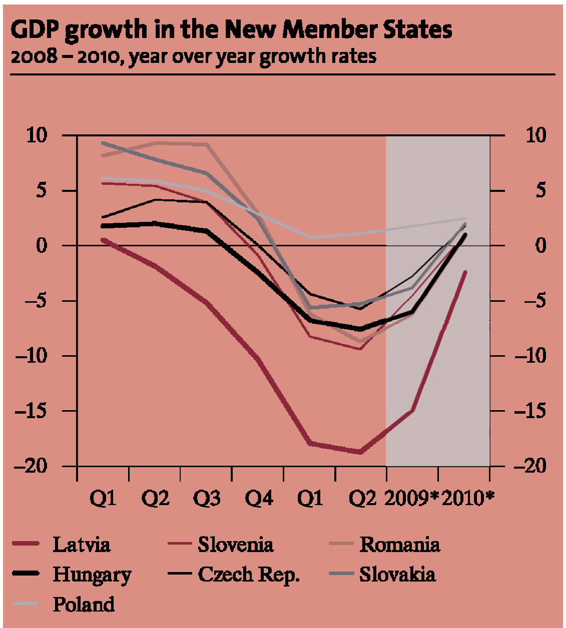
Sharp contraction of GDP in 2009 in most countries

In the New Member States (NMS) of the European Union, the recession continued in the second quarter of 2009, and on a regional average, real GDP dropped by 4.8% compared with the second quarter of last year. The largest NMS economy, *Poland*, however keeps resisting the negative growth impacts of the international crisis: after a growth of 0.8% in the first quarter, Polish GDP achieved a positive yearly growth of 1.4% in the second quarter (Graph 1).

In sharp contrast, the *Baltic economies* declined dramatically: their GDPs fell by around 15-20%. Here, growth and particularly consumption as well as labour market trends are alarming, and we expect a double-digit fall for the whole of 2009. Nevertheless, unlike most international financial market analysts, in our view a general collapse – including a currency crisis and subsequent drastic depreciation, hyperinflation and dramatic impoverishment – is probably avoidable. Following the example of Estonia, Latvia – the country that came into an acute critical position from the beginning of the year – is also applying the policy of 'internal devaluation' that among others implies a drastic *nominal* decrease of public sector wages and pensions. At present, Lithuania seems to be the weakest point; however, in case of need, this country could also count on the financial support from the International Monetary Fund as well as the European Commission, especially because of the restrictive measures already undertaken by the Lithuanian government.

The GDP decline is less pronounced in the other NMS; the expected fall for the whole of 2009 is between 3-6%, which thanks to the positive performance of the Polish economy implies a GDP drop of 3% for the regional average. Economic growth will be at a low level also in 2010 (around 1.5%) and a stronger upturn can be expected only for 2011.

Graph 1



Source: National Statistical Offices. – *Kopint-Tarki forecasts.

The quarter-on-quarter growth trends imply a *gradual improvement of the prospects*: in this dimension, besides Poland, the two Euro area members, Slovenia and Slovakia, as well as the Czech Republic also registered slight positive growth in the second quarter, while the fall of GDP moderated in Romania, Hungary and even in the brutally depressed Baltic States.

During the current crisis, the real convergence performance of the NMS is evidently heterogeneous. The previous fast convergence of the Baltic countries turned into a marked divergence, and the convergence of Hungary and Romania also halted. In the meantime, Slovenia, Slovakia, the Czech Republic and the poorest country of the region, Bulgaria, have kept their convergence towards the more developed West-European economies. The performance of Poland is particularly noticeable: according to our forecast, Polish GDP per capita in purchasing power terms will overtake the Latvian and Lithuanian indicators in 2010, and its value will be close to Hungarian and Estonian levels.

Severe cuts in consumption and investment

Although the economic recession is widespread, the social perception and the societal consequences of it are obviously different, mainly because of the marked differences in the dynamics of household consumption. Household consumption fell by around 20% in the Baltic States, by 15% in Romania and by almost 5% in Hungary and Bulgaria. In contrast, in Poland, the Czech Republic and Slovakia a slight positive change in household consumption was recorded in the second quarter of this year (i.e. the likely low point of the crisis).

The fall in investment is general in the region. Not surprisingly, the Baltic countries (-40%) and Romania (-25.2%) recorded the largest declines. The significant drops in investment in Slovenia and Slovakia are the post-accession features of the Euro area membership of these two economies. In previous years, inclusion in the common currency area had produced an upsurge in the Slovenian and Slovakian investment rates; hence the magnitude of the present decline also includes an inevitable correction, altogether resulting in a decrease of 20-25%. Although the drop in investment was markedly lower in Hungary (-3.3%), we have to bear in mind the painfully low *investment level* of the Hungarian economy, which unlike Slovenia and Slovakia has still not experienced the positive investment impacts associated with accession to the EMU.

However, in a time of deep crisis, the national accounts statistics reflect a much higher level of measurement uncertainty than usual. This is especially problematic to make a distinction between a change in inventories and statistical error (discrepancy) on the demand side. As a result, the evaluation of investment trends (changes in gross fixed capital formation) has rather uncertain statistical fundamentals. Although overall gross capital formation is falling at a significantly higher rate than gross fixed capital formation, the difference between the two categories is close to zero in Romania, around 10–15%-points in Slovenia, Slovakia, the Czech Republic and Poland, while it is close to 30%-points in Lithuania and exceeds 40% in Hungary. Consequently, in the future we expect significant corrections in the regional national accounts statistics, at least regarding the demand structure of GDP.

Besides the general decline in investment, another impact of the crisis (valid for all of the countries of the region) is the double-digit fall in external trade volumes. Although the declines in exports and imports have been mainly simultaneous, in the second quarter of 2009 the fall in exports moderated somewhat compared with the first quarter, while that of imports accelerated. This was especially true in the countries that were forced to implement drastic stabilization measures to restrict internal demand because of external imbalances and/or positions of financial vulnerability (the Baltic States and Romania, and to a lesser extent Bulgaria and Hungary).

Not only industry was hit by the crisis

Regarding the supply side of GDP, the trends of the previous quarter continued. There was a steep fall in industrial production (by 5-25% in the different countries), but the recession also had more pronounced impacts on the market service sectors. However, the Visegrád countries typically registered positive growth in the construction and the non-market service sectors, thanks to their higher degree of freedom for fiscal manoeuvring and the subsequent ability of enhancing internal demand via temporary fiscal incentive measures. As a result of the contraction of the activity, major imbalances appeared regarding the fiscal balance and the labour market

The above trends evidently implied a significant deterioration in the general government balances. In 2007, the fiscal positions still looked sound and stable; the deterioration started in 2008, and in the summer months of 2009 it became clear that all of the NMS countries impinged on their fiscal barriers. Despite the brutal restrictive measures, the dramatic decline of GDP results in a General Government Balance deficit of around 8% of GDP in Latvia and Lithuania, but also the Polish and Slovakian governments (both of them hesitating for a long time) have had to face the limits of their fiscal expansion opportunities (Table 1).

Table 1

General Government Balances
2007 – 2010, in % of GDP

	2007	2008	2009[a]	2010[a]
Bulgaria	0.1	1.5	-0.4	0.1
Hungary	-4.9	-3.4	-3.9	-3.8
Estonia	2.7	-3.0	-4.2	-4.2
Slovenia	0.5	-0.9	-4.7	-4.0
Czech Rep.	-0.6	-1.5	-5.2	-5.1
Poland	-1.9	-3.9	-6.2	-5.2
Slovakia	-1.9	-2.2	-6.3	-5.5
Romania	-2.5	-5.4	-7.3	-6.2
Lithuania	-1.0	-3.2	-7.5	-6.0
Latvia	-0.4	-4.0	-9.7	-8.2
Ew Member States, avg.	-1.0	-2.6	-5.5	-4.8
Euro area	-0.6	-1.9		
EU-27	-0.8	-2.3		

Sources: Eurostat, Eastern Europe Consensus Forecast August 2009, Kopint–Tarki Database. – [a]Forecast.

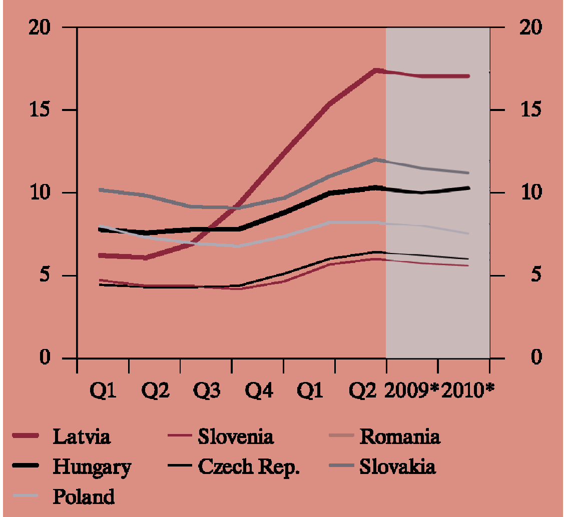
From the general trend of large fiscal imbalances, an exception might be Bulgaria, where the recently nominated minister of finance, Simeon Djankov (a highly respected former economist at the World Bank) intends to conserve the balanced budget position by introducing additional restrictions. Regarding the fiscal trend of the last couple of years, Hungary presents a paradox: the country that had by far the worst fiscal position in 2007 will probably have the second lowest deficit in 2009–2010.

Albeit with a delay, labour market indicators definitely reflect the deteriorating growth trends. In the second quarter of 2009 employment decreased in each of the NMS countries, in the Baltic States by 7-10%. The Visegrád countries and Bulgaria, however, experienced a less pronounced decrease in employment by only 1–2%.

Simultaneously, unemployment is continuing its rising trend (Graph 2). Not surprisingly, we can observe the most critical tendencies again in the Baltic countries. At the beginning of 2008 the unemployment rate in the Baltic States was still around 5%. Since then, the number of jobless people has increased sharply to 15% in Estonia and in the range of 15-20% in Latvia and Lithuania. We do not expect any improvement in the short run as further fiscal restrictions imply additional lay-offs. As it is practically true for all countries of the region, we expect a growth in the regional unemployment rate of more than 2 percentage points, from 6.4% to 8.5%. A decrease of joblessness might occur in the second half of 2010, which technically implies stagnation for the average unemployment rate next year.

Graph 2

Unemployment in the New Member States
2008 – 2010, standardized rates in %



Source: EUROSTAT. – *Kopint-Tarki forecast.

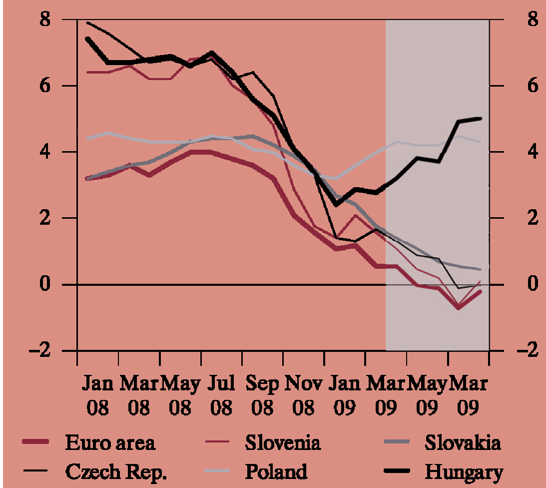
Pronounced deceleration of inflation

Since the summer of 2008, inflation has been rapidly decelerating in the new EU member countries, partly as a result of stubbornly low international food and energy prices and partly as a consequence of declining demand.

Among the Central European countries, Hungary and Poland are exceptions, as in these two countries inflation has turned into a rising trend since the beginning of the year. In Hungary, the basic cause was the mid-year hike of taxes and excise duties, while in Poland the

Graph 3

Inflation rates in the Euro area and selected New Member States
2008 – 2009, %



Source: EUROSTAT.

relatively strong household consumption largely explained the persistent inflation rate of around 4% (Graph 3). However, not only the two Euro area members (Slovenia and Slovakia) followed the falling trend of consumer prices of the Euro area, but since June there has also been deflation in the Czech Republic. The most peculiar case is that of Estonia where in the summer months of 2008 inflation was still close to 12% and, after a steady period of disinflation, the 12—months inflation rate also showed a declining trend. A similar tendency could be observed in the two other Baltic countries and in Bulgaria: starting from the high levels (of between 13 and 18%), the 12-months inflation rate dropped to 2.5% in Latvia, to 3% in Lithuania and to 1% in Bulgaria.

The price tendencies by product groups clearly indicate that this disinflation is a main consequence of the rapid decline of energy prices and a simultaneous drop of food prices. In the Baltic countries, the mid-year energy price increase of 25% in 2008 turned into a negative trend: this year, falling energy prices were the main reasons for the decline in inflation. In the Visegrád and the Balkan countries, however, the two prominent product groups played a rather similar role in the disinflation process. Until the end of the year, rising oil prices may push up the energy and raw material prices; as result of this and of the expected more positive growth trends a moderate increase of inflation will likely recommence.

Still higher risk premium on financial markets

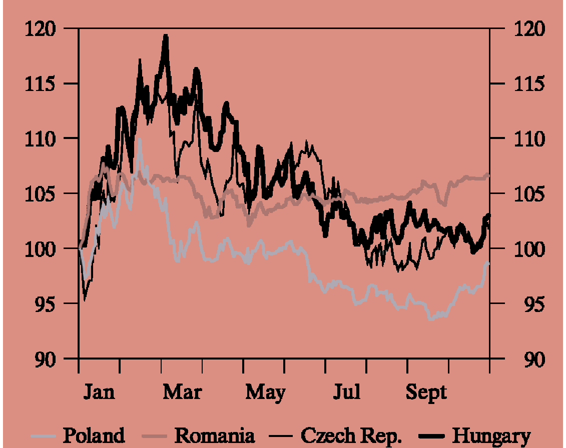
The improvement on the international financial and capital markets implied an increasing risk appetite towards the emerging markets. The demand for Central and Eastern European financial assets has markedly grown and caused a new appreciation of local currencies.

Compared with the euro, both the Hungarian forint and the Polish zloty practically regained their values, compensating for the loss of more than 15% at the beginning of the year (Graph 4). The two currencies have followed slightly different paths: since March, the appreciation of the forint followed a clearer trend, while the zloty remained more volatile and again weakened temporarily at the beginning of this summer. In the meantime, the Romanian leu could not regain its value-loss from the beginning of 2009, while the Czech koruna stabilised in the spring months and has appreciated further since July.

The CDS country default swaps fell below 250 base points and the long-term state bond yields of the Visegrád countries also decreased somewhat. In the last two

Graph 4

Exchange rates of selected NMS against the Euro
2009, January 2nd = 100



Source: ECB.

Table 2

GDP-Growth, Inflation and Unemployment in the New Member states
2008–2010, in %

	GDP			Inflation[1]			Unemployment		
	2008	2009*	2010*	2008	2009*	2010*	2008	2009*	2010*
Bulgaria	6.0	–3.0	1.0	12.0	2.2	2.0	5.6	6.8	7.0
Czech Republic	3.0	–2.8	1.8	6.3	0.7	2.0	4.4	6.2	6.0
Estonia	–3.6	–12.0	0.0	10.6	0.2	0.3	5.5	14.5	13.0
Hungary	0.6	–6.0	1.0	6.0	4.3	4.0	7.8	10.0	10.3
Latvia	–4.6	–15.0	–2.5	15.3	3.4	–3.0	7.5	17.0	17.0
Lithuania	3.0	–14.0	–3.0	11.1	3.7	–1.5	5.8	16.0	17.0
Poland	5.0	1.8	2.5	4.2	3.8	2.7	7.1	8.0	7.5
Romania	7.1	–6.2	0.8	7.9	5.2	3.5	5.8	7.4	8.0
New Member states	4.1	–2.8	1.5	6.2	3.2	2.5	6.4	8.5	8.4

Source: Eurostat. – [1]Harmonised Index of Consumer Prices. – *Kopint-Tarki forecasts Sep. 2009.

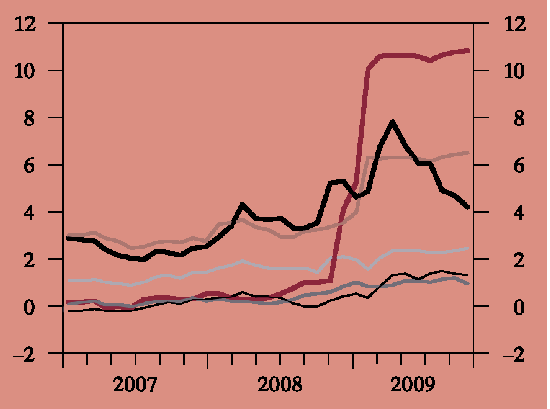
months, the largest fall occurred in Hungary, where the positive fiscal trends finally turned the former persistent increase in yields into a marked fall. As a result, following the other countries of the region with a delay, the Hungarian central bank has cut the base rate four times and the cuts will probably continue till the end of the year.

Nevertheless, long-term state bond yields remained high in the Baltic countries, underlining the continued distrust of international investors. The position of Romania is also uncertain: although since spring the Romanian National Bank has cut its base rate twice, and in the meantime the long-term state bond yields increased by almost 300 basis points (Graph 5). Obviously, at present investors still consider the prospects of the Romanian economy rather unstable; as a result, the recent base rate cuts might be followed by new hikes in the near future.

In the last couple of months, international investors have tended to differentiate more among the NMS countries and, in the improving international business climate, the countries' macroeconomic fundamentals define the attractiveness of the local financial assets. At present, it seems

Graph 5

Government Bond Yields in selected NMS
2007 – 2009, Differences from Euro area yields



Source: Eurostat. – 10 years government bonds.

that the trust towards the Visegrád countries will increase further, thus the local currencies and stock market indices will probably rise, while their state bond yields will likely fall further. However, the revitalisation of the Baltic and Balkan financial and capital markets will certainly occur later, this process might be drawn out until mid-2010.

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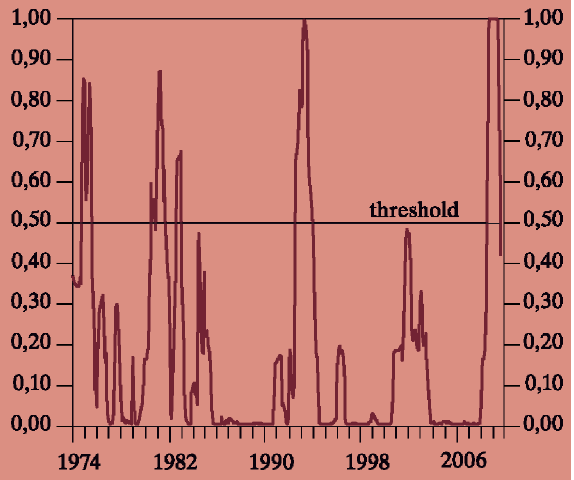
Coe-Rexecode Start-End Recession Index for the Euro Area

According to the Coe-Rexecode Start-End Recession Index for the Euro area, the recession may have ended during the summer. The index fell strongly between July and August from 0.78 to 0.58 and should have fallen again to 0.42 in September, according to preliminary data, crossing therefore the significance threshold of 0.5. Three of the four components of the indicator contribute to this signal. Household confidence and car sales had already rebounded. Recently, the industrial index has been revised to show a significant upsurge. Only the unemployment rate is still on the rise and does not contribute to the signal. This recession ending was a necessary condition to validate our forecast of a growth cycle trough in the third quarter we made in the July 2009 Euren newsletter, based on the May signal. The anticipation of a growth rate climbing quickly over the trend growth rate (estimated at 1.1 % at an annual rate) is also under way to be confirmed. In September, the Coe-Rexecode "underlying" monthly growth indicator in the euro area was already assessed at an annualised rate of 1.9 %, climbing strongly from -0.9 % in July and +0.6 % in August.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: October 19, 2009

	08Q1	08Q2	08Q3	08Q4	2008	09Q1	09Q2	09Q3	09Q4	2009
Aug-08		1,6 ; *–0,1*	1,1 ; *0,2*	1,3 ; *0,5*	1,5					1,2
Sep-08	[2,2 ; *0,7*]	[1,5 ; *–0,2*]	0,9 ; *0,0*	1,1 ; *0,6*	1,4					0,9
Oct-08			0,8 ; *0,0*	0,7 ; *0,2*	1,3	0,5 ; *0,5*				0,5
Nov-08			0,8 ; *0,0*	0,4 ; *0,0*	1,2	–0,2 ; *0,1*				0,0
Dec-08			0,7 ; *–0,1*	0,0 ; *–0,4*	1,1	–0,6 ; *0,1*				–0,5
Van-09	[2,1 ; *0,7*]	[1,4 ; *–0,2*]	[0,6 ; *–0,2*]	–0,7 ; *–1,0*	0,9	–1,8 ; *–0,4*	–2,0 ; *–0,4*			–2,0
Feb-09				–0,9 ; *–1,2*	0,8	–2,4 ; *–0,8*	–2,7 ; *–0,5*	–2,9 ; *–0,4*	–2,7 ; –0,5	–2,7
Mar-09	[2,2 ; *0,7*]	[1,4 ; *–0,3*]	[0,6 ; *–0,2*]	[–1,3 ; *–1,5*]	[0,7]	–2,7 ; *–0,8*	–3,5 ; *–1,1*	–3,6 ; *–0,3*	–2,6 ; –0,5	–3,1
Apr-09					[0,7]	[–2,7 ; *–0,7*]	[–3,2 ; *–0,8*]	[–3,1 ; *–0,1*]	[–2,0 ; –0,4]	–2,7
May-09					[0,7]	[–3,8 ; *–1,7*]	[–3,0 ; *0,6*]	[–2,5 ; *0,3*]	[–1,2 ; –0,4]	–2,6
Jun-09	[2,2 ; *0,7*]	[1,4 ; *–0,3*]	[0,6 ; *–0,2*]	[–1,4 ; *–1,6*]	[0,7]	[–4,7 ; *–2,6*]	[–3,9 ; *0,6*]	[–2,9 ; *0,8*]	[–1,0 ; 0,3]	–3,1
Jul-09					[0,7]		[–3,7 ; *0,8*]	[–2,3 ; *1,2*]	[–0,2 ; 0,5]	–2,7
Sep-09	[2,2 ; *0,7*]	[1,5 ; *–0,3*]	[0,5 ; *–0,2*]	[–1,7 ; *–1,6*]	[0,7]	[–4,9 ; *–2,6*]	[–4,7 ; *0,8*]	[–3,1 ; *1,3*]	[–0,7 ; 0,7]	–3,3
Oct-09					[0,7]			[–3,2 ; *1,2*]	[–0,7;0,8]	–3,4

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.
In Q2 2009, the EUROSTAT figures have one again triggered a downward revision of the HFM estimates for 2009, as year on year figures were worse than expected. Therefore the annual rate for 2009 is now estimated -3,4% instead of the formerly published -3.1%. Any case, the model indicates a clear recovery path for the second half of 2009. The quartlerly figures are positive numbers since the second quarter.
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