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THE IMPACT OF THE GLOBAL ECONOMIC CRISIS ON THE PUBLIC FINANCES OF CENTRAL AND EASTERN EUROPEAN COUNTRIES

Tomáš DUDÁŠ[*]

ABSTRACT

The aim of this paper is to examine the impact of the global economic crisis on public finances in Central and Eastern Europe. The first part of the paper examines the major trends in public finances in these countries in the pre-crisis period in 2000-2007. The second part of the paper is dedicated to the development of public finances in the crisis and post-crisis period and we are trying to identify the most problematic and least problematic states on the level of the region.

Key words: Global Economic Crisis, Central and Eastern Europe, Budget, Public Debt, Slovakia

JEL classification: F01, H62, H63

INTRODUCTION

Management of public finances is one of the most important tasks of the economic policy of any sovereign state. Budgets with long-term public deficits inexorably lead to debt financing and to the consequent rise of public debt. After a certain point, however, the willingness of private investors to finance the public debt reduces significantly and this development often leads to national bankruptcy. Historically, such problems were mainly related to developing countries in Latin America and Africa. However, at present the public debt crisis threatens economically developed countries, even members of the prestigious OECD group. The situation is not fundamentally different in Central and Eastern Europe, where several countries had to ask international organizations for help in dealing with their debt services.

The global financial crisis of 2008/09 and the subsequent global economic crisis have meant the greatest turbulence in the global economy since the oil price shocks in the 1970s. There was a serious threat to the global financial sector in autumn 2008, when the global financial markets were on the brink of total collapse. The global financial system was ultimately saved by the economically developed countries, which took over the debts of their private banks and then tried to revitalize their economies through large financial stimuli packages. The result of this development has been a significant deterioration of the public deficits in these countries and the consequent rise of public debt. Currently, the average debt level of the OECD countries reached more than 110 % of their respective GDP, what is the highest level of public debt in peacetime history (Abbas et al, 2010). In comparison with the OECD countries, countries in Central Europe had only minor problems with their banking sectors, but governments in the region often used deficit financing to cover rising budget expenditures. Hence, several countries of the region reached a point, where they had serious problems with public debt sustainability even before the global financial crisis. The global financial crisis has only exacerbated this

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problem, pushing several countries (ex. Hungary) over the brink of sustainable debt servicing (OECD, 2011).

The aim of this article is to examine the impact of the global economic crisis on the public finances in the countries of Central and Eastern Europe. The first part of the paper assesses the main trends in public finances of these countries in the pre-crisis period of 2000-2007. In this part we try to identify the countries that were the most vulnerable before the outbreak of the global financial crisis. The second part of the article is devoted to the development of public finances in the crisis and post-crisis period. Once again, we are trying to identify the most problematic and least problematic states and the policies used to deal with the rising budget deficits.

For the purposes of this article we defined Central and Eastern Europe as a region of 23 states, linked by a common history – a centrally planned economic system, which these countries operated until 1989. However, after more than twenty years of economic transformation, the region is well structured internally. That is why we created several groups within the region for our further analysis. The first group consists of ten EU Member States from Central and Eastern Europe, representing the most advanced part of the region. In 2004, eight countries from the region joined the EU (Czech Republic, Hungary, Poland, Slovakia, Slovenia, Lithuania, Latvia and Estonia) and in 2007 they were followed by Bulgaria and Romania. A second group of countries consists of Western Balkan states, which arose after the breakup of Yugoslavia (Croatia, Serbia, Montenegro, Macedonia and Bosnia and Herzegovina) and Albania. This is a rather heterogeneous group, but most of these countries are ultimately heading to the EU. The last group consists of former parts of the Soviet Union, which became independent after the breakup. The Russian Federation, Ukraine, Belarus, Moldova, Georgia, Armenia and Azerbaijan belong to this group for the purposes of our article. This very a diverse group, which includes both the largest exporter of oil and natural gas in the world (Russian Federation) as well as the last centrally planned economy in Europe (Belarus).

The analysis in our article is based on publicly available data from various international organizations. The data used in this paper comes from the Eurostat (EU member states) and the International Monetary Fund, in particular from the on-line database of the latest edition of the IMF World Economic Outlook - April 2013.

1. Development of public finances in Central and Eastern Europe in the years 2000 - 2007

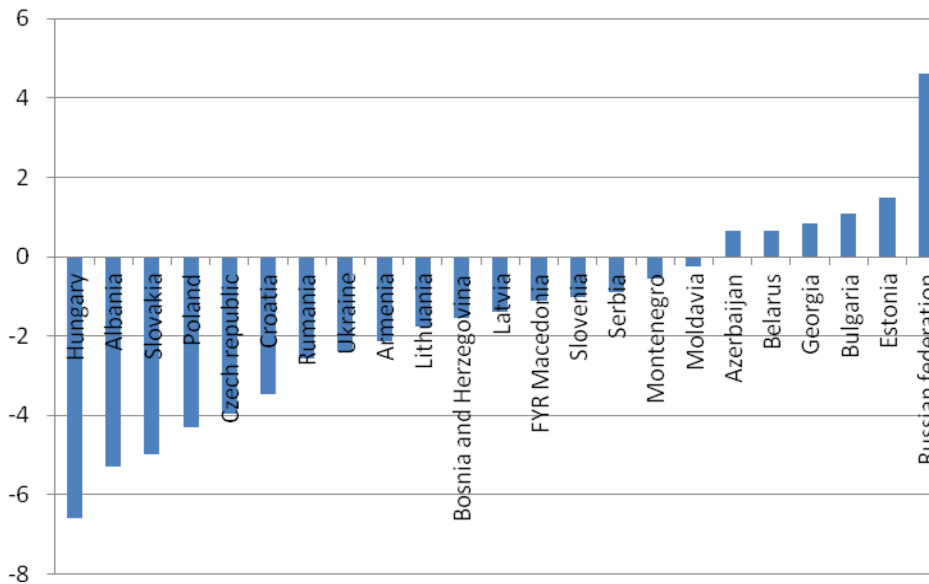
Public finances were a neuralgic point in Central and Eastern Europe even before 1989, and their deterioration to a large extent led to the collapse of centrally planned economies. Several states have started the process of economic transformation with a significant debt (ex. Hungary and Poland) and unbalanced government budgets remained a serious problem in the region throughout the 1990s. Slovakia can serve as a notable example in this area, as it has never had a balanced or surplus state budget since gaining independence in 1993. Some states in the region even experienced a total financial meltdown, the best example is probably the financial collapse of the Russian Federation in 1998 (Tanzi and Schuknecht, 2000).

At the beginning of the new millennium, however, the majority of countries in the region have already endured the worst years of economic transformation and this positive change was also reflected in the gradual improvement of the public finances in these

countries. Still, if we consider the period before the global economic crisis (2000 - 2007), it should be noted that budget deficits were still dominant in the majority of the countries in Central and Eastern Europe. The situation in this time period is reflected in Fig. 1, which contains data on the average balance of the government budgets of the 23 countries surveyed between 2000 and 2007. Of this sample, only six states showed a continuously balanced or surplus budget. The remaining 17 states were characterized by constant budget deficits.

The largest surpluses in the period under review have been documented in the Russian Federation, which, however, benefited from its strong exports of raw materials. High oil and natural gas prices on the world markets ensured strong revenues to the state budget, increasing the average budget surplus in this period in Russia to 4.6 % of GDP. On the other hand, Estonia was a significantly positive example of responsible fiscal policy, which recorded an average surplus of the government budget amounting to 1.5 % of GDP in the period under review. The Estonian governments are the epitome of fiscal responsibility, and Estonian fiscal policy can serve as a "best case" example for most countries in the region (Schneider and Zapal, 2005). Good results were achieved between 2000-2007 also in Georgia, Belarus and Azerbaijan. Nevertheless, in their case, the statistics of public finances has to be taken with a grain of salt.

Figure 1: The average balance of government budgets in the countries of Central and Eastern Europe in the years 2000-2007 (% of GDP)



Source: On-line statistical database IMF World Economic Outlook – April 2013

Contrariwise, the worst result in the period analyzed has been recorded by Hungary, where the irresponsible fiscal policies of several successive governments resulted

in a very vulnerable state of public finances (Győrffy, 2007). The severity of the Hungarian fiscal problems was confirmed in 2008, when the turbulences in the global financial markets almost caused the financial collapse of the country, which was forced to ask for IMF assistance. The data on Fig. 1 show, that the fiscal situation in Slovakia between 2000 and 2007 was also not without problems. Although the country recorded the highest GDP growth among OECD member countries during the time period (OECD, 2011), Slovakia had serious problems with high budget deficits. We conclude that in this period Slovakia wasted a precious chance to significantly consolidate its public finances, because a similar period of high economic growth cannot be expected in the near future. The year 2007 can serve as a memento, when a record GDP growth of 10.2 % was not enough to create a balanced state budget (deficit of 1.8 % of GDP).

Table 1: The level of public debt in Central and Eastern Europe between 2000 and 2007 (% of GDP)

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Bulgaria	***72.5***	***66.0***	***52.4***	***44.4***	***37.0***	***27.5***	***21.6***	***17.2***
Czech republic	17.8	23.9	27.1	28.6	28.9	28.4	28.3	27.9
Estonia	5.1	4.8	5.7	5.6	5.0	4.6	4.4	3.7
Latvia	12.4	14.1	13.6	14.7	15.0	12.5	10.7	9.0
Lithuania	23.6	23.0	22.2	21.0	19.3	18.3	17.9	16.8
Hungary	***56.1***	***52.7***	***55.9***	***58.6***	***59.5***	***61.7***	***65.9***	***67.0***
Poland	36.8	37.6	42.2	47.1	45.7	47.1	47.7	45.0
Romania	22.5	25.7	24.9	21.5	18.7	15.8	12.4	12.8
Slovenia	26.3	26.5	27.8	27.2	27.3	26.7	26.4	23.1
Slovakia	50.3	48.9	43.4	42.4	41.5	34.2	30.5	29.6
Albania	69.6	65.9	65.5	60.7	57.4	57.8	56.7	53.4
Bosnia and Herzeg.	34.7	35.2	31.2	27.6	25.5	25.5	21.2	18.6
Croatia	n/a	n/a	34.8	35.4	37.6	38.2	35.4	32.9
FYR Macedonia	47.9	48.8	42.9	37.9	35.6	39.5	32.0	24.0
Montenegro	n/a	n/a	75.7	40.3	45.3	38.6	32.6	27.5
Serbia	**241.7**	**114.5**	**81.2**	**77.8**	**65.4**	**56.3**	**42.2**	**34.6**
Armenia	39.4	37.8	38.1	32.9	26.4	20.5	16.2	14.2
Azerbaijan	22.8	24.2	22.9	21.7	20.2	13.3	10.2	8.6
Belarus	n/a	n/a	n/a	n/a	9.7	8.4	11.1	18.3
Georgia	n/a	n/a	n/a	n/a	43.6	34.1	27.1	21.5
Moldova	96.9	82.9	66.2	56.9	42.5	34.4	30.4	25.2
Russia	59.9	47.6	40.3	30.4	22.3	14.2	9.0	8.5
Ukraine	45.3	36.5	33.5	29.4	24.7	17.7	14.8	12.3

Source: On-line statistical database IMF World Economic Outlook – April 2013

The positive development is that despite the deficit financing of government budgets in the years 2000 – 2007, there was a decline in the average level of debt in our sample of 23 countries from Central and Eastern Europe. According to IMF data, the average level of public debt in the region, decreased from 51.7 % of GDP in 2000 to 24 % in 2007 (IMF, 2009). A similar (albeit more limited) improvement could be observed in the group of new EU member states, where the average public debt declined from 32.3 % of GDP in 2000 to 25.2 % of GDP in 2007. The main factor behind this positive development

was a period of high economic growth in the global economy, which empowered a large number of countries in the region to significantly reduce the proportion of their public debt.

The most spectacular results of debt reduction were reached between 2000 and 2007 in Serbia. The break-up of Yugoslavia and the subsequent political regime led by Slobodan Milosevic left Serbia with an overwhelming level of public debt (Upchurch and Marinković, 2011). In 2000, the level of Serbian public debt reached a staggering 241.7 % of GDP and the Serbian governments had to tackle this serious issue after the regime change. After the year 2000, the Serbian economic policy combined a multi directional approach consisting of new financial arrangements with international creditors, attraction of foreign direct investment and privatization of public assets to the private sector (Laušev et al., 2011). The policies of the Serbian governments were very largely successful and the level of public debt relative to the GDP decreased by 207.1 percentage points between 2000 and 2007 (see Fig. 1).

Bulgaria can serve as another positive example, as it reduced its public debt from 72.5 % of GDP to 17.2 % of GDP between 2000 and 2007. Bulgaria used the period of high economic growth very well, using sensible fiscal policies. Similarly positive results have been achieved also in Slovakia, where the high economic growth outweighed the unaspiring fiscal policy. This led to a reduction in public debt from 50.3 % of GDP in 2000 to 29.6% of GDP in 2007. The most positive example of this period is nevertheless Estonia, which maintained a very low level of public debt through the whole time period. The level of the Estonian public debt was only 3.7 % of GDP in 2007, thus being the lowest in the whole sample of 23 countries of Central and Eastern Europe.

Of course, not all countries managed their public debts as successfully as Estonia, Bulgaria or Slovakia. Hungary recorded the highest level of public debt relative to GDP in in 2007 and the country managed to increase their debt by more than 11 percentage points in relation to the GDP between 2000 and 2007 (Table 1). This was the result of unsustainable fiscal policy started by the government of Viktor Orbán and continued by the subsequent governments led by Péter Medgyessy and Ferenc Gyurcsány. It was already evident in early 2008, that the level of the public debt is a significant weakness of the Hungarian economy. Czech Republic and Poland also increased their public debt in the period under review, but they managed to contain the public debt on a sustainable level.

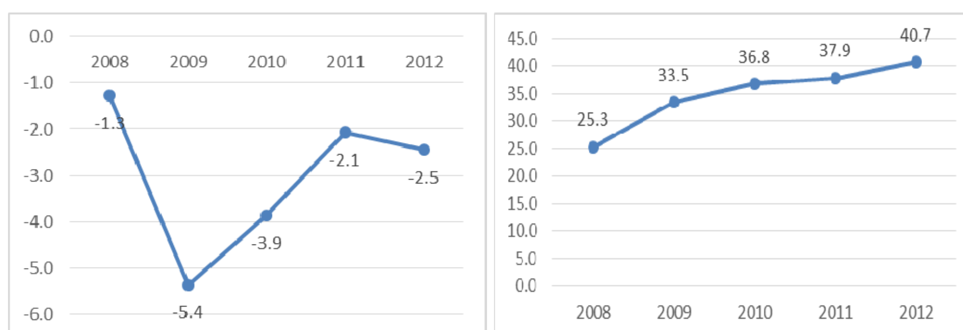
2. DEVELOPMENT OF PUBLIC FINANCES IN CENTRAL AND EASTERN EUROPE POST-CRISIS IN THE YEARS 2008 – 2012

Although the roots of the global financial and economic crisis in 2008 and 2009 were in the U.S., its effects have quickly spread throughout the global economy. Since most countries in Central and Eastern Europe belong to smaller economies dependent on exports, the crisis has affected them very quickly with the negative trends already visible in the second half of 2008. The drop in exports led to a slump in industrial production and GDP creation, which in turn led to an increase in unemployment and consequent rise in social spending. 2009 was the worst year in the region, when all countries except Poland plunged into economic recession (Global Finance, 2011).

The collapse of GDP in each country of the region was also accompanied by a decline in tax revenues and increased government spending. The result was the deterioration of public finances in all surveyed countries of Central and Eastern Europe.

The data in Fig. 2 clearly show that while in 2008 the average budget deficit of the 23 countries surveyed was only 1.3 % of GDP, in 2009 this deficit deteriorated significantly to the level of 5.4 % of GDP. Unfavorable development of public finances in the region continued subsequently in 2010 and 2011, although the starting recovery of the global economy has brought some improvement in this area. Needless to say, that in 2011 the average general government balance in the region was still worse than in the beginning of the crisis in 2008 (-2.1 % of GDP). The situation did not improve in 2012, although several governments in the region realized the need for a fiscal consolidation. Some countries like Slovakia or Poland improved their public finances, but the position of the region as a whole deteriorated as the average budget deficit reached 2.5 % of the GDP.

Figure 2: Average balance of state budgets and public debt in the countries of Central and Eastern Europe in the years 2008 - 2012 (% of GDP)



Source: On-line statistical database IMF World Economic Outlook – April 2013

Big exporters of mineral resources located in the region are specific cases, as the collapse in oil prices on world markets in the second half of 2008 caused a serious shortfall in their budget revenues. The collapse of oil prices on the world markets was felt very seriously in the Russian Federation, where the general government surplus of 4.9 % of GDP in 2008 turned into a deficit of 6.3 % of GDP in 2009. Azerbaijan was also a similar case, as it is also strongly dependent on oil exports. In 2008, the Azerbaijani government recorded a surplus in excess of 20 % of GDP, whereas this surplus has shrunk to only 6.8% of GDP in 2009. The prices of natural resources recovered in 2010, but the oil exporting countries in the region were not able to reach the budget surpluses that were common before the global economic crisis.

Of course, the average of the whole region conceals considerable differences in the management of public finances in the sample countries. All states except Azerbaijan recorded a public deficit in 2009, but its level fluctuated from 0.7 % of GDP to 9.8 % of GDP. The Baltic States were among the countries hardest hit by the global economic crisis, so it was therefore not surprising that the highest deficit in the region was recorded in Latvia (9.4 %) and it was closely followed by Lithuania (7.8 %). Estonia had only a relatively small budget deficit in 2009 (2.0 %), but the mere existence of a negative budget balance indicates the severity of the economic problems of the country in that given year.

The situation of public finances in Slovakia was also not encouraging in the years 2009 and 2010. The government of Robert Fico allowed an increase of the budget deficit by almost 6 percentage points in 2009 in comparison with 2008, when the deficit skyrocketed to 8.0 % of GDP. The situation did not improve significantly in the year 2010, when the budget deficit remained on the level of 2009 (7.9 %). The situation of other countries in Central Europe was not much better. The budget deficit in Poland was almost on the level of Slovakia in 2009 (7.3 %) and the public deficits in Czech Republic (5.8 %) and Hungary (4.6 % of GDP) also attacked 5 % of GDP.

The negative development of public finances in Central and Eastern Europe caused an increase in the public debt in the region. The average level of public debt in the region rose from 25.3 % of GDP in 2008 to 33.5 % of GDP in 2009 (see Fig. 2), which meant a steep increase in the public debt by 8.1 percentage points. The increase in public debt continued in 2010 and 2011, although the pace slowed considerably. The average public debt in the 23 surveyed countries grew in 2010 by 3.3 percentage points and in 2011 only by 1.2 percentage points. Data from of the 23 countries included in the sample reveals that in the between 2008 and 2010 the level of public debt increased in all the countries studied.

Table 2: The level of public debt in Central and Eastern Europe between 2008 and 2013 (% of GDP)

	2008	**2009**	**2010**	**2011**	**2012**	**2013f**
Bulgaria	13.7	14.6	16.2	16.3	18.5	17.8
Czech republic	28.7	34.2	37.8	40.8	45.8	44.8
Estonia	4.5	7.2	6.7	6.2	10.1	9.7
Latvia	**19.8**	**36.9**	**44.4**	41.9	40.7	41.0
Lithuania	**15.5**	**29.3**	**37.9**	38.5	40.7	40.0
Hungary	73.0	79.8	81.8	81.4	79.2	79.9
Poland	47.1	50.9	54.8	56.2	55.6	56.8
Romania	13.4	23.6	30.5	34.7	37.8	36.9
Slovenia	22.0	35.0	**38.6**	**46.9**	**54.1**	68.8
Slovakia	27.9	35.6	41.0	43.3	52.1	55.3
Albania	54.7	59.3	57.8	58.6	60.6	61.8
Bosnia and Herzeg.	31.0	35.9	39.3	40.4	44.3	42.1
Croatia	29.3	35.8	42.6	47.2	56.3	59.5
FYR Macedonia	20.6	23.8	24.4	28.2	33.3	34.3
Montenegro	29.0	38.2	40.9	46.0	51.1	52.9
Serbia	33.4	38.1	**46.5**	**50.0**	**63.7**	64.7
Armenia	14.6	34.1	33.7	35.5	39.5	42.6
Azerbaijan	7.3	11.8	11.1	10.1	11.6	13.9
Belarus	21.7	34.9	42.0	43.4	36.9	33.8
Georgia	27.6	37.3	39.2	33.8	32.7	31.2
Moldova	18.8	26.7	26.5	23.1	23.8	22.5
Russia	7.9	11.0	11.0	11.7	10.9	10.4
Ukraine	20.5	35.4	40.5	36.8	37.4	42.2

Source: On-line statistical database IMF World Economic Outlook – April 2013

The increase in public debt in the region was indeed worrying, but compared to the highly indebted Eurozone countries such as Greece, Italy or Portugal the level of public debt was still at a manageable level in the region. This does not mean, however, that in the future public debt can easily grow further, as financial markets now react to such developments with rapid increase in interest rates on government bonds. Most governments in Central and Eastern Europe do realize the severity of the situation and several states have already implemented some form of debt ceiling limiting the amount of public debt relative to GDP to their constitutions.

Naturally, the average levels of public debt in Central and Eastern Europe are hiding significant differences. The IMF data clearly shows that Hungary has currently the highest level of public debt relative to GDP in the region. The previously mentioned years of irresponsible fiscal policies led to a situation where the country's level of public debt amounted to 81.8 % of GDP in 2010. There are certainly higher levels of public debts in Europe, but already this level is unsustainable in the long term for a small open economy such as Hungary. Any economic or financial turbulence can lead to a loss of confidence of the financial markets, which leads to problems with debt financing. The situation of Hungary in 2008 was a clear evidence of the possible debt financing dangers, as the country was forced to use a joint IMF, EU and World Bank assistance of 25.1 billion USD in order to avoid sovereign debt bankruptcy (IMF, 2008). At present, the Hungarian public finances are still in a vulnerable state, as evidenced by the country's tentative negotiations with the IMF about possible further financial assistance.

To assess the evolution of public debt in Central and Eastern Europe, it is important to look at the overall dynamics of its growth between 2008 and 2012. The majority of the countries in the region suffered the worst debt shock in 2009 and 2010. The highest growth of public debt in this period was recorded by two Baltic States - Lithuania and Latvia. Both countries were strongly affected by the global economic crisis and both economies experienced a large bubble in the housing market. The result of severe economic problems has been a meteoric growth of public deficits, which led to the growth of public debt in Lithuania by 24.6 percentage points and in Latvia by 22.4 percentage points relative to GDP. Ukraine (19.5 percentage points) and Belarus (19.3 percentage points) also experienced a significant increase in public debt between 2008 and 2010. Especially Belarus had serious problems with financing its public debt and was forced to accept financial assistance from the Russian Federation in the amount of 3 billion USD (Businessweek, 2011). These sources, however, there were not sufficient, since in the spring of 2012 Belarus requested further loan from the IMF (BelausDigest, 2012).

While most countries in Central and Eastern Europe stabilized their public debts in 2011 and 2012, there were countries that were pushed to public debt problems by the international financial markets in these years. Slovenia, once a poster child of the region, experienced a considerable rise of public debt between 2010 and 2012. A crisis of the big state owned banks led to rising public deficits and to a public debt reaching 54.1 % of the GDP in 2012. According to the predictions of the IMF the situation is going to be even worse in the near future with the public debt culminating on the level of 75 % of the GDP in 2015 (IMF, 2013). The severity of the situation can by illustrated by the fact that the Slovenian government is considering to seek assistance from the EU bailout funds. Serbia experienced a similar increase of public debt in 2011 and 2012 as the level of public debt increased by 17.2 percentage points between 2010 and 2012. The level of Serbian public

debt is currently reaching the threshold of sustainability what is reflected in the rising interest rates of the Serbian government bonds in the financial markets (National Bank of Serbia, 2013).

Slovakia belonged to the group of relatively lightly indebted countries in Central and Eastern Europe at the start of the global financial crisis (27.9 % of GDP at the end of 2008). However, the high budget deficits between 2009 and 2011 caused a dynamic growth of public debt in Slovakia. The public debt of Slovakia reached 52.1 % of the GDP in 2012. This means that the level of the Slovak public debt almost doubled relative to the GDP between 2009 and 2012. The dangerous dynamics of the public debt was recognized by the Slovak government and a constitutional debt brake was introduced in March 2012. This debt ceiling limits the amount of Slovak public debt to 60 % of GDP. Moreover, the Ministry of Finance must prepare corrective measures as soon as the amount of the public debt reaches 50 % of GDP. As this level was reached in early 2013, it will be very interesting to follow the future development of the Slovak public debt and the subsequent reaction of the Slovak government.

CONCLUSION

At the moment, most countries in Central and Eastern Europe are aware of the seriousness of the situation in the area of public finances, and therefore almost all states started to consolidate their government budgets after 2010. On the other hand, the latest available IMF forecasts suggest that a deeper reduction of the budget deficits in the region cannot be expected before 2018. According the IMF, the average level of public deficits in Central and Eastern Europe will oscillate around 2.5 % of GDP between 2013 and 2018. While this level of deficits is certainly sustainable in the long run, a further consolidation would be needed to tackle the increasing levels of public debt. A changing paradigm in the European fiscal policy is not helping the consolidation efforts, as the IMF and EU is starting to advocate public spending as a way out of the economic recession instead of fiscal consolidation. The Fiscal Compact in the EU could be a positive influence for the public finances in Central and Eastern Europe, but only ten countries from the region are members of the EU. Moreover, a relaxing of the fiscal goals can be anticipated in the EU in the coming years.

Nonetheless, even a slightly improved budgetary discipline will lead to a gradual stabilization and reduction of public debt of the countries in the region. Most of the countries in the sample will stop to create new debt in the coming years, although there will be exceptions (ex. Slovenia or Serbia). Governments in the region comprehend the fact that a high level of public debt is more expensive to service due to rising interest rates on the international financial markets, what reduces the amount of financial resources available to fulfill the basic tasks of government. In several countries of Central and Eastern Europe, public debt is already at unsustainable levels and its return to a sustainable level may take more than a decade.

In conclusion, the global financial and economic crisis has greatly deteriorated the business cycle of all countries in Central and Eastern Europe and some states have been pushed to a financial position that is not sustainable in the long term (ex. Hungary or Belarus). The good thing is that by now, all governments recognize the seriousness of the situation and are actively seeking to improve their fiscal policies. On the other hand, any weakening of the global economic growth or a possible global recession may significantly

undermine the efforts of the states in Central and Eastern Europe to manage their public finances and may drive more states in the region into a state of fiscal unsustainability.

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