

Fiscal Policies

Fiscal outcomes in 2008 are in line with government plans, except in the Baltics and Romania. In all three Baltic countries, revised and weaker 2008 budget targets are at risk under a sharper than expected economic slowdown, despite further expenditure cuts envisaged for this year. Estonia's budget will probably shift to a deficit for the first time this decade despite sizable spending reductions of about 1.2 percent of GDP. The fiscal deficit will also widen in Latvia, where the government is mulling spending cuts beyond the earlier planned staffing reductions. In Lithuania, the government estimates fiscal deficit to widen substantially to 2.35 percent of GDP, up from initially planned 0.5 percent of GDP, as revenues from indirect taxes have fallen short of targets and spending cuts did not materialize ahead of the October parliamentary elections.

Fiscal developments in the other EU10 countries were mixed this year. This outcome reflects to a large extent buoyant revenues, thanks to higher growth and inflation (in Bulgaria, Hungary and Romania), hikes in indirect taxes, despite cuts in personal income tax rates in four out of ten countries. Stronger inflows of EU funds have also helped support revenues. However, spending has also risen strongly reflecting increases in pensions (Romania) and other social transfers, public sector wages and subsidies (in particular, in Hungary to the railway company). For 2008 as a whole, the fiscal deficit is projected to widen in the Baltic, Republic, Poland and Romania, in the latter despite exceptionally strong growth. Bulgaria's fiscal surplus should remain broadly unchanged at 3.2 percent of GDP for 2008, while Hungary's fiscal deficit should ease to 3.4 percent of GDP, thanks to buoyant tax collection.

Fiscal developments in 2009 will reflect the projected weaker economic expansion in all EU10 countries, slowing inflation and sustained pressure in many countries to compensate for this year's high price increases by boosting social spending. Only Bulgaria of all the EU10 countries plans and is likely to achieve a general government surplus in 2009 of about 3 percent of GDP. In Romania, weaker growth as well as a 50-percent hike in teachers' salaries will likely lead to deficit widening toward 3.7 percent of GDP and above this year. The 2009 budget in Poland projects the general government deficit to remain broadly unchanged at about 2 percent of GDP in 2009, but achieving this outcome will be challenging given the projected slowdown in economic activity. In Hungary, the budget targets the deficit to narrow to 2.9 percent of GDP in 2009 under the assumptions that additional saving measures are introduced early on in 2009. The government has already withdrawn the previously planned tax cut package and reduced the original spending ceiling by 1 percentage points of GDP. Major spending cuts that have been recently proposed concern pension, road and railway spending and family subsidies (Table 2).

The fiscal challenges will likely be the greatest for the Baltic countries, given the weak economic activity. According to the central bank, fiscal deficit in Estonia is likely to widen to 2.5 percent of GDP despite government attempts to balance it, including by reducing outlays by 10 percent. The government also plans to scrutinize more closely welfare benefits and introduce measures to boost revenues, including by hiking the preferential VAT rate, shifting some goods and services to the regular VAT rate and putting on hold plans to cut further the income tax rate. Latvia's central government targets the fiscal deficit to widen to 1.85 percent of GDP in 2009 from a balanced budget in 2008. On the spending side, the government plans a public sector wage freeze, cuts in civil service employment by 10 percent and reductions in the operational cost of government institutions by more than 10 percent. Nonetheless, the budget is based on the overly optimistic assumption of real GDP growth of 2 percent, which according to the central bank, risks deficit widening to 4-5 percent of GDP in the worst-case scenario. In

Table 2. 2009 Fiscal Adjustment in Hungary

Tax Revenues:

- Downward revision of macroeconomic forecasts (-0.85% of GDP);
- Elimination of planned tax cuts (+0.5% of GDP).

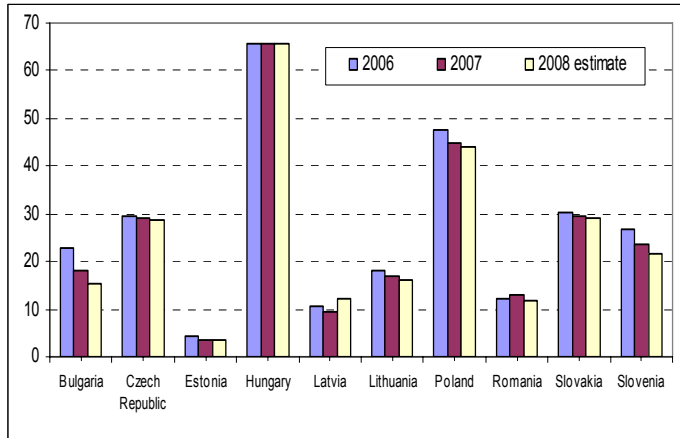
Expenditure Cuts to compensate for the revenue loss and reduce deficit from the originally planned 3.2% to 2.9% of GDP:

- Freeze of real wage in the public sector;
- Administrative cost cuts of line ministries (0.1% of GDP);
- Lower pension spending due to lower wage increase and inflation (almost 0.2% of GDP)
- Specific pension correction delayed to September (almost 0.1% of GDP)
- Increase of family benefits delayed to September (almost 0.1 of GDP);
- Cut of public transport price subsidy;
- Reduction of subsidies to rail and road passenger transport (0.1% of GDP)
- Capital spending reduction (0.1% of GDP).

Source: MOF

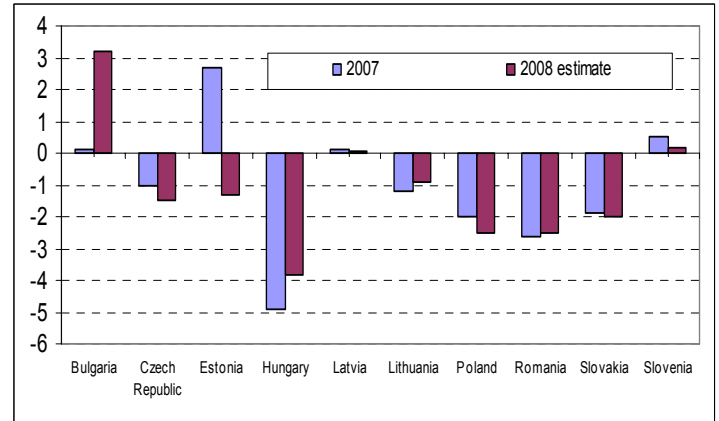
Lithuania, the current draft 2009 budget envisages the deficit of 2.3 percent of GDP (for general government excluding social security fund), despite repeated calls to government institutions to cut spending levels.

Figure 20. General Government Debt, 2006-2008 (% of GDP)



Sources: Eurostat, Ministries of Finance, World Bank staff calculations.

Figure 21. General Government Balance, 2007-2008 (% of GDP)



Note: A decrease in Bulgaria's fiscal surplus in 2007 from 3.4 percent of GDP is due to new information on a debt cancellation towards Iraq.

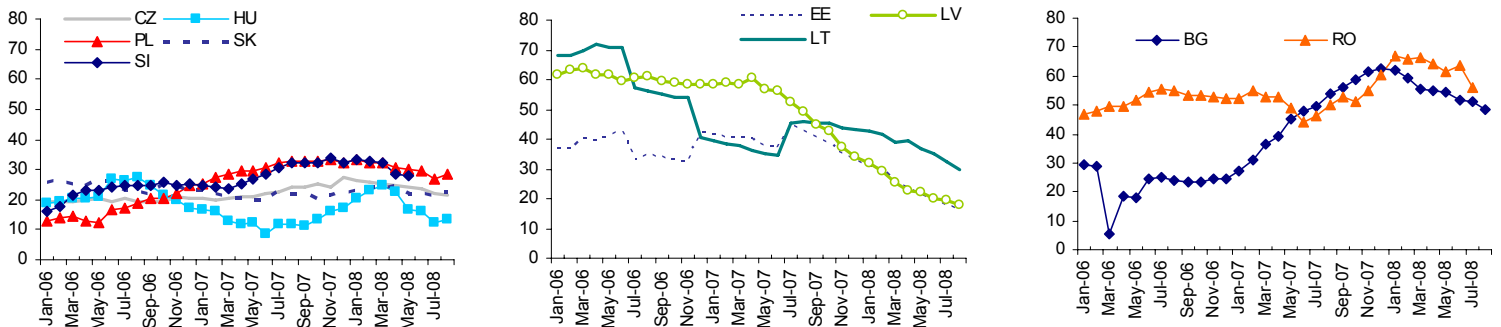
Sources: EDP Notification, October 2008, Eurostat, staff calculations.

As the EU10 adjust to the ongoing slowdown in growth and pressure on revenues and budgets, it will be important not to put the burden of adjustment on targeted social protection spending. Indeed, times of economic downturn require continued commitment to well-funded and well-targeted social protection schemes to help alleviate the pressure on the most vulnerable members of society. It will also be important to ensure that fiscal policies are not pro-cyclical, as they were in many EU10 countries during the times of strong economic growth. Counter-cyclical fiscal policies help build cushions to use in times of need, and they help limit macroeconomic and fiscal imbalances.

Monetary Developments

In the course of only a few months, the emphasis of central banks in the region has shifted from reacting to rising inflation to dealing with the possibility of a stronger decline in inflation and the global financial turmoil. In the Czech Republic, large exchange rate appreciation led the central bank to cut its key policy rate by 25 basis points in August to 3.5 percent. Despite earlier expectations of further monetary tightening, central banks decided to keep rates unchanged in September in Hungary, Poland and Romania, given easing inflation pressures and the ongoing financial turbulence.

Figure 22. Credit to Private Sector (% change, yoy)



Source: Central Banks

The tighter financial conditions, growing concerns about credit risk amid the intensifying global financial crisis and weakening economic expansion have resulted in slower growth in domestic credit in most countries (Figure 22). Banks are tightening lending requirements, which, together with slowing demand for