Public Finance in the Western Balkans and the impact of the current crisis

EFP Seminar
September 2010
Budva
Montenegro

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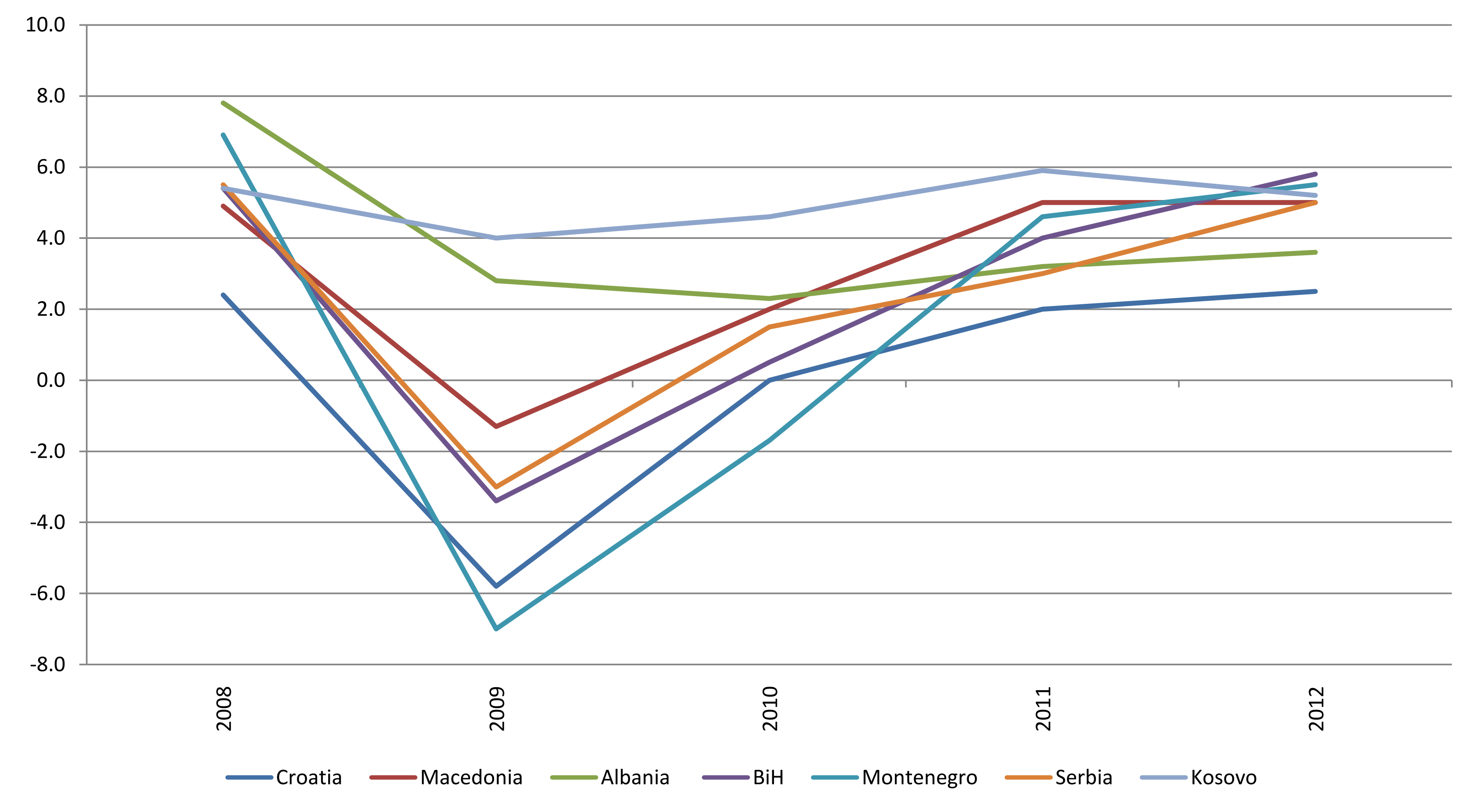
Fiscal fundamentals in 2010

- Outlook is more favorable among emerging economies than among advanced economies where the cyclically adjusted fiscal balance is expected to improve this year relative to last.
- However, even among these economies, the projected improvement in the fiscal balance this year is barely half that projected in November 2009.
- Over the medium term, these economies continue to be expected to run primary deficits.
- Emerging economies will still be exposed to interest rate and growth shocks, including as a result of fiscal spillovers from advanced economies.
- These developments are occurring amid heightened market sensitivity to variations in fiscal performance across countries. Many countries will be facing historically high financing requirements this year, making them especially susceptible to market pressures.

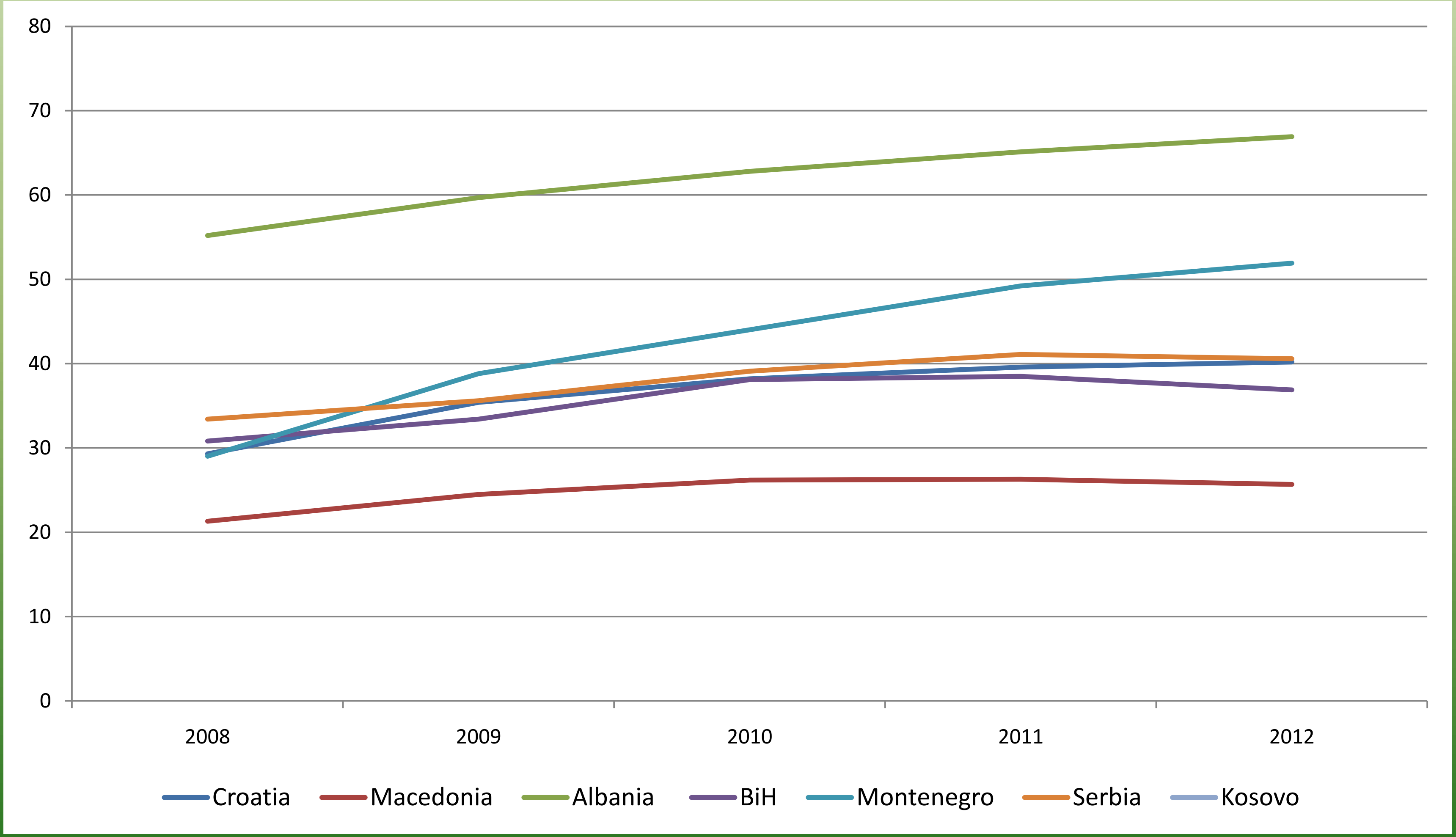
Source: IMF Fiscal Monitor-May 2010

Western Balkan GDP Growth Projections



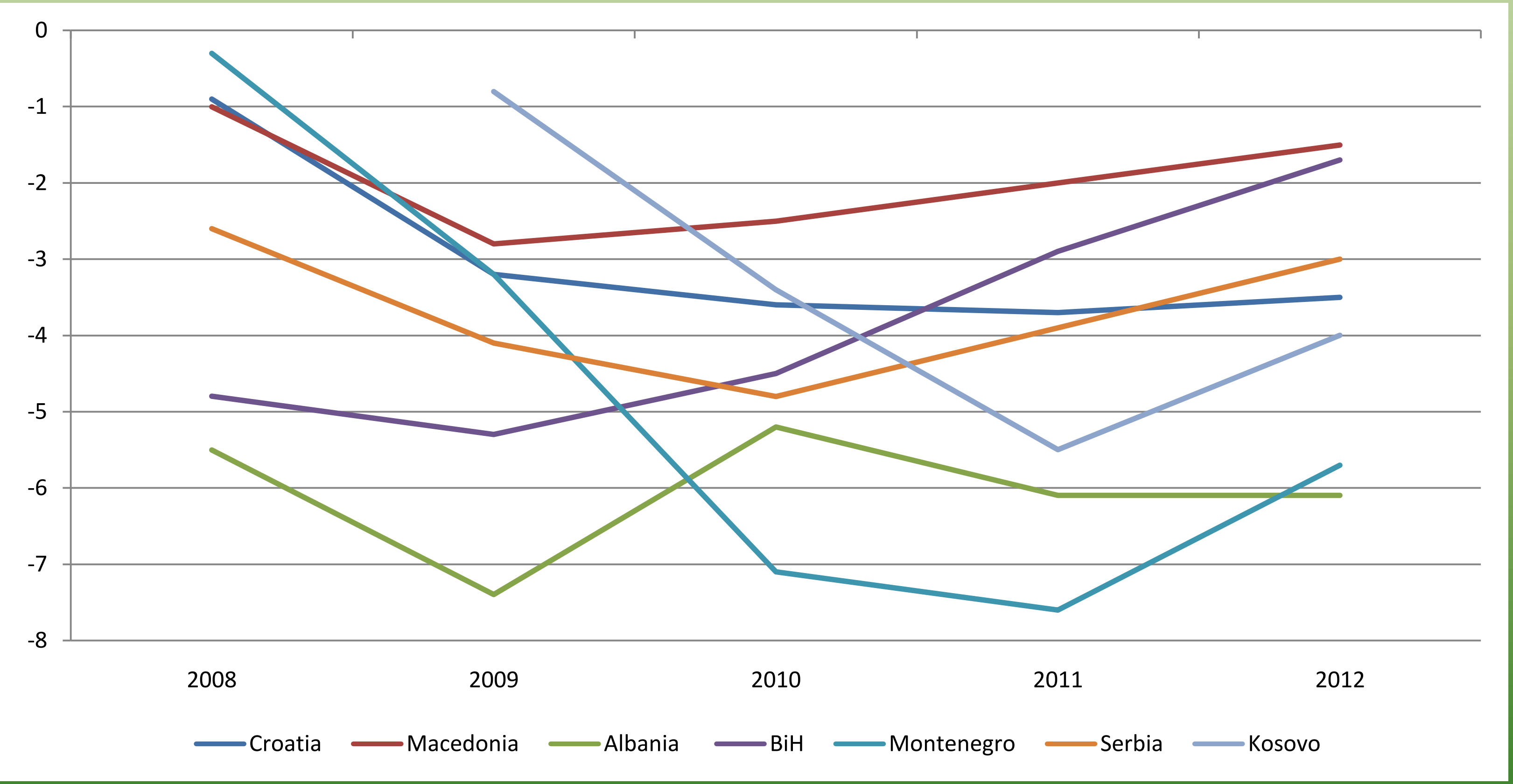
Source: IMF Staff reports

Western Balkan General Government Debt Levels



Source: IMF Staff reports

Western Balkan General Government Fiscal Balances



Source: IMF Staff reports

Market Indicators

- Government financing needs remain exceptionally high in most advanced economies.
- Financing needs remain more "moderate" among emerging economies including Western Balkans but not by any means negligible
- Yields and spreads have evolved favorably for emerging economies relative to advanced countries particularly peripheral Eurozone countries
  - With increased risk appetite and an associated search for yields, demand for emerging economy sovereign debt rose sharply, leading to shrinking emerging market spreads.
  - The changing perception of sovereign risk is also reflected in a divergence of CDS spreads between advanced and emerging economies
- But will it last?

CDS spreads Advanced versus Emerging markets.

Fiscal Risks for Western Balkan economies

- A less favorable interest rate-growth differential a key source of risk for emerging economies-including Western Balkans.
- Projected declines in debt ratios assumes a negative interest rate-growth differential, which offsets the continued primary deficit.
- Less accommodating developments
  - possibly due to deteriorating public finances in advanced economies-a real risk at present
  - could lead to higher global interest rates and a lower growth rate—public debt ratios in emerging economies could start rising again.
  - Some criticism of over-optimistic forecasts authorities –growth, government revenues-by country has been noticeable (e.g. 2010 EC EFP evaluations)
- Increased government guarantees to financial and real sector as response to the fiscal crises

Financing Needs for Advanced Economies

Advanced Economies' Gross Financing Needs, 2010
(In percent of GDP, unless otherwise specified)

	Maturing Debt	Deficit	Gross Financing Needs	Gross Debt	Average Maturity (years)
Australia	2.0	-5.0	7.0	15.5	4.8
Belgium	20.8	-5.1	25.9	97.3	5.4
Canada	15.9	-5.3	21.2	82.5	5.6
France	16.9	-8.2	25.1	77.4	6.5
Germany	10.2	-5.7	15.9	72.5	6.0
Greece	13.4	-8.1	21.5	115.1	7.4
Ireland	7.7	-12.2	19.9	64.5	6.7
Italy	21.2	-5.2	26.4	115.8	6.7
Japan	54.2	-9.8	64.0	217.7	5.2
Portugal	13.0	-8.8	21.8	77.1	6.2
Spain	10.3	-10.4	20.7	55.2	6.7
Sweden	6.8	-3.3	10.1	40.9	6.0
United Kingdom	8.6	-11.4	20.0	68.2	12.8
United States	21.2	-11.0	32.2	83.2	4.4

Sources: April 2010 WEO for deficit and debt; Bloomberg and IMF staff estimates for maturing debt and average maturities.

Western Balkan Gross Financing Needs Euro Bn

	2010	2011	2012	2013	2014	2015
Croatia	6.6	7.1	6.2	6.4	7.3	7.5
Macedonia	0.3	0.3	0.3	0.4	0.4	0.5
Albania	1.0	0.8	0.9	0.1	0.8	1.2
BiH	1.0	1.0	0.8	0.7	0.8	0.8
Montenegro	0.4	0.4	0.4	0.4	0.4	0.5
Serbia	3.1	3.9	4.1	4.5	4.3	4.5

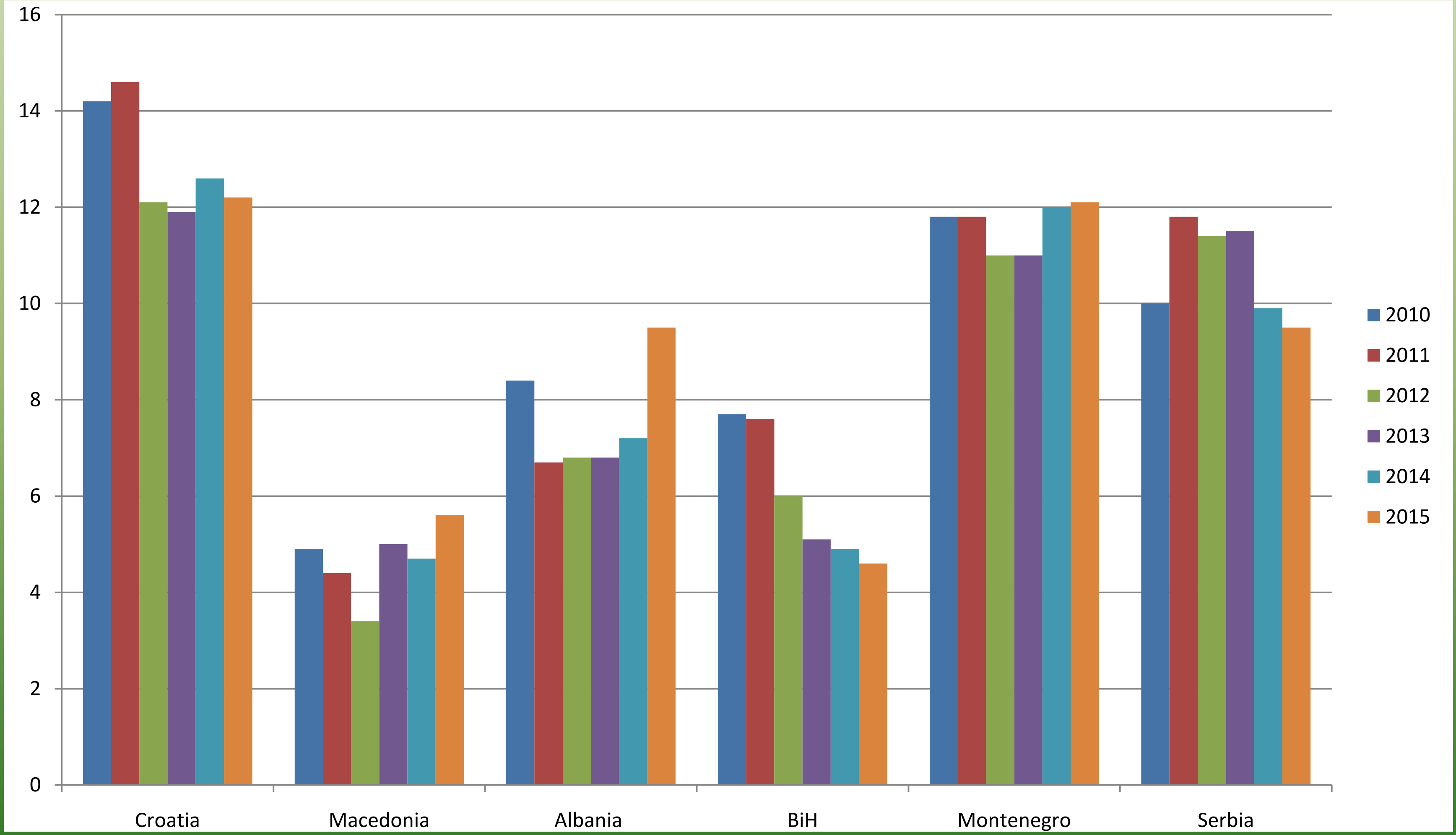
Source: IMF Staff reports

Western Balkan Gross Financing Needs
% GDP

	2010	2011	2012	2013	2014	2015
Croatia	14.2	14.6	12.1	11.9	12.6	12.2
Macedonia	4.9	4.4	3.4	5	4.7	5.6
Albania	8.4	6.7	6.8	6.8	7.2	9.5
BiH	7.7	7.6	6	5.1	4.9	4.6
Montenegro	11.8	11.8	11	11	12	12.1
Serbia	10	11.8	11.4	11.5	9.9	9.5

Source: IMF Staff reports

Western Balkan Gross Financing Needs
% GDP



Source: IMF Staff reports

Is Living With Higher Debt an Option?

- High debt may lead to higher interest *rates.* It will certainly lead to a higher interest *bill*
- High debt levels are associated with lower investment and slower growth
- They are also associated with higher macroeconomic volatility, perhaps because capacity to respond to future shocks is constrained
- Implications of having so many high debt countries at once are uncertain, and market response may be sudden and decisive

Source IMF Fiscal Monitor –May 2010

So what will be the impact on public finances?

- Initial post-crisis growth momentum may be slowing-both in advanced and SEE countries.
- Economic recovery will be gradual when growth resumes
- Increased debt levels have reduced fiscal space-even for those with relatively low levels (e.g. Macedonia)-needs to be restored over the medium-term
- Financing options uncertain, both due to domestic banking and external (competition for capital) factors.
- Fiscal risks remain elevated due to continued uncertainty over financial and real sectors of the economy
- Downside risks still high-contagion is still a worry if Eurozone sovereign debt crises exacerbates.

Exit strategies must be anchored within a medium-term fiscal consolidation process

- Fiscal policy and budget management should be cast within comprehensive medium-term frameworks.
- This may include new institutional arrangements and procedural or numerical rules that provide incentives for overcoming the deficit bias
- Desirable features include
  - a clear legislative and regulatory structure that establishes responsibilities; accountability and reporting requirements for all agencies involved in fiscal policy;
  - publicly available information on the underlying macroeconomic and fiscal forecasts; an assessment of fiscal risks;
  - clear medium- to long-term objectives for various components of the public sector; and
  - independent evaluation of the integrity of fiscal information and performance against set objectives.

Medium-Term Fiscal Consolidation process

Issues that remain to be addressed in Western Balkans

- Strengthening fiscal institutions capacity to develop and implement medium-term fiscal frameworks will be key
- Fiscal rules may be warranted to guide policy, particularly when a deficit bias persists
- Rules may also be needed when other disciplining mechanisms are weak or where supranational commitments have to be respected (e.g SGP)

Strong budget institutions increase the probability of successful consolidation processes

- Enable better understanding of the scale and scope of the fiscal challenge through
  - comprehensive, timely and credible fiscal reporting,
  - robust medium-term fiscal projections,
  - quantification of longer-term structural issues that raise sustainability concerns), and
  - disclosure and management of fiscal risks
- Improves capacity to monitor and enforce fiscal discipline

Strong budget institutions increase the probability of a successful fiscal consolidation process

- Assist with development of credible fiscal consolidation strategy through
  - Medium-term budget framework setting limits on medium-term spending commitments.
  - Commitment to credible and achievable transparent medium-term fiscal objectives or rules.
- Improves capacity to implement the consolidation strategy through the budget process.

Medium-term budget frameworks-How do they help the public finances?

- Instill greater fiscal discipline by constraining budget appropriation and execution in future years to levels consistent with the Government’s medium-term fiscal and sectoral objectives. (Finance Ministries)
- Facilitate more strategic prioritization of expenditure by abstracting from the immediate pressures and legal constraints that impinge upon the annual budget process. (Presidents, Prime Ministers and Planning Ministers)
- Encourage more efficient inter-temporal planning of expenditure by providing greater transparency to budget holders about likely future resources. (Line Ministries)

Medium-term Budget Frameworks

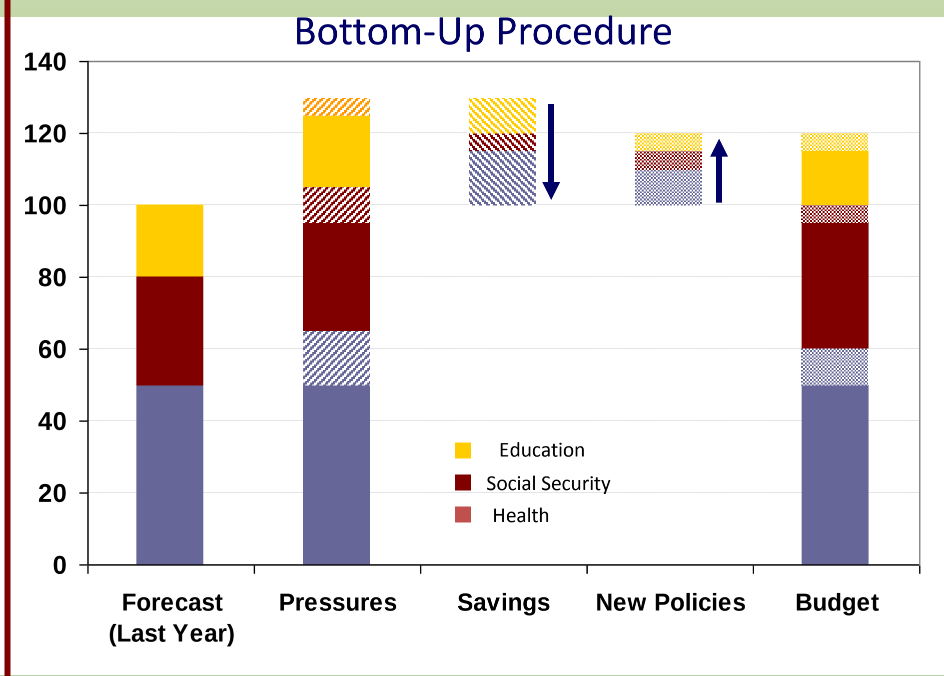
Range of Advanced Country Approaches

COUNTRY	COVERAGE				LEVEL OF DETAIL	TIME HORIZON	DISCIPLINE	
	Soc Sec	Debt Interest	Local Gov't	% of public spending			Rolling or Fixed	Frequency of Revision
AGGREGATE EXPENDITURE CEILINGS								
Sweden	Yes	No	T'fers	64%	Total Spending	3	2 fixed + 1 rolling	Every year
Finland	Some	No	No	36%	Total Spending	4	4 fixed	Every 4 years
Netherlands	Yes	No	T'fers	80%	4 Sectors	4	4 fixed	Every 4 years
FIXED MINISTERIAL PLANS								
United Kingdom	No	No	T'fers	59%	25 Depts	3	3 fixed	Every 3 years
France	No	Yes	No	31%	35 Missions	3	2 fixed + 1 rolling	Every 2 years
ROLLING PROGRAM ESTIMATES								
Australia	Yes	Yes	Yes	100%	20 Depts 267 Progs	3	Rolling	Every year

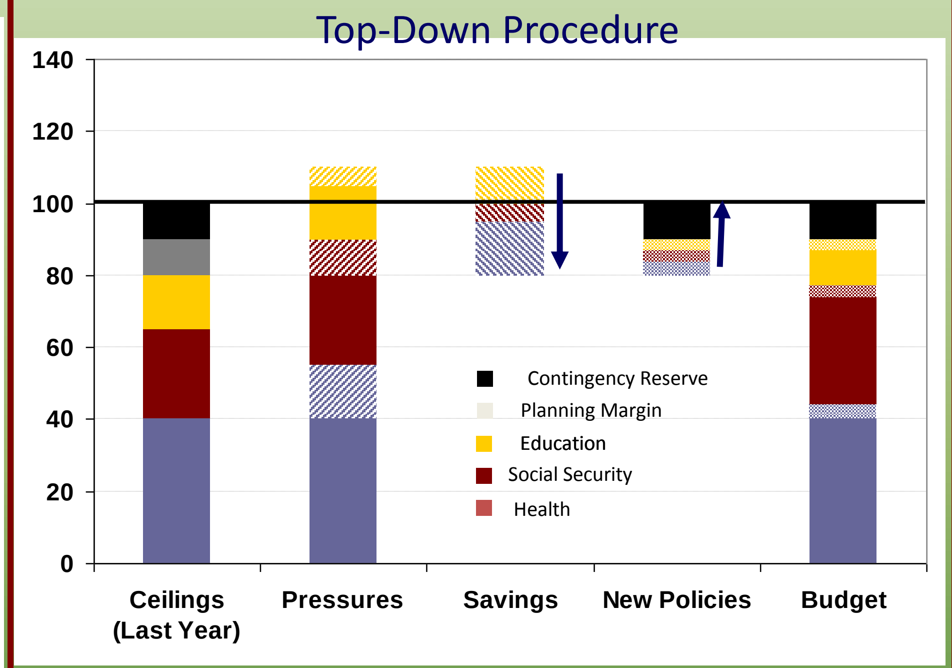
Medium-term budget Frameworks What’s needed to enable successful implementation ?

- Early political commitment to expenditure ceiling(s)
  - Coalition Agreement (NL, Finland)
  - Parliamentary Vote (Sweden, France)
  - Government White Paper (UK)
- Ceilings broken down by ministry (not just economic category)
- Estimates reflect full costing of all tax and spending policies
- Ceilings becomes budgets in the absence of agreed
  - Forecast changes
  - New policies
- Margins built into multi-year forecasts to deal with the above

Top-down budgeting:
Integrating ceilings into the budget process



- No ceilings given to line ministries at start of budget process
- No provision for a planning margin or contingency reserve
- No clear guideline for quantum of savings required



- Aggregate & ministerial expenditure ceilings fixed in previous budget
- Planning margin and contingency margin built into ceiling
- Clear guideline for quantum of savings required to respect ceiling

Fiscal Rules

- Fiscal rules increasingly popular among advanced and emerging markets-By 2009, 80 countries had fiscal rules in place.
- Fiscal rules are a mechanism for placing durable constraints on fiscal discretion through numerical limits on budgetary aggregates.
- They entail numerical targets or ceilings for specific fiscal indicators (or a combination); procedures to deal with deviations from targets; incentives for authorities to abide by the rule; and effective monitoring and enforcement procedures.
- Well-designed and implemented rules can strengthen governments' accountability for fiscal outcomes vis-à-vis their set objectives, thus enhancing the quality, transparency, and credibility of fiscal policy.

Fiscal Rules

- The timing for the introduction of rules is also important. May not be appropriate for countries facing large fiscal consolidation needs
- Must be accompanied by coherent fiscal framework
- Implementing a fiscal rule involving fiscal targets that are appropriate for the medium term might result in an unfeasible pace of fiscal adjustment. Attempts at implementation might lead to loss of credibility
- May need to bring deficits and debt under control through necessary fiscal adjustment before considering implementing a rule.

Increasing use of independent fiscal agencies (Fiscal Councils)- including SEE region

- Fiscal Council objective to hold government accountable to meeting policy objectives and ensure the realism of underlying assumptions, forecasts and policies.
  - Independent fiscal council-gaining in popularity in the CE and SEE region (Hungary, Slovenia, Romania)
- Role of Fiscal Councils differ -3 main models
  - Agencies that provide objective analysis of current fiscal developments, and costing of budgetary initiatives (e.g. Netherlands CBP).
  - Bodies that produce independent projections and forecasts regarding both the budgetary variables as well as the relevant macroeconomic variables (Hungary)
  - Institutions that, in addition to the above tasks, have the mandate to provide normative assessments, including on the appropriateness of fiscal policy stance (US, Korea)

Increasing use of independent fiscal agencies (Fiscal Councils)- including SEE region

- But need to be realistic about what is achievable in low capacity environments.
- Risk of shifting too many fiscal responsibilities to an independent council, usurping functions that are rightly the responsibility of the executive, and leaving substantial gaps in the MoF

Role of Fiscal Councils

	EX ANTE		EX POST
	Validate Macro Assumptions	**Scrutinize Fiscal Policy**	**Evaluate Fiscal Performance**
Canada None	Uses ave of private sector forecasts for GDP growth	None	None
UK Office for Budget Responsibility	Produces forecasts for the economy and public finances	Makes judgment on whether fiscal policy is consistent with a better than fifty per cent chance of achieving fiscal mandate	None
Netherlands Central Planning Bureau	• Full economic forecast • Research on economic issues	Costs election platforms & Coalition Agreement	None
Sweden Fiscal Policy Council	Evaluates transparency & credibility of govt forecasts	Assesses sustainability of fiscal policy	Monitors compliance w/ 1% surplus target
Hungary Fiscal Council	• Full economic forecast • Baseline fiscal projections • Budget impact of all legislation • Methodological recommendations	Advises govt / parl on • Fiscal policy • Transparency • Accounting	Upon request