PLATFORM FOR DISCUSSION

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FISCAL STANCE AMIDST RISING RISKS AND INTEREST RATES – THE CESEE PERSPECTIVE

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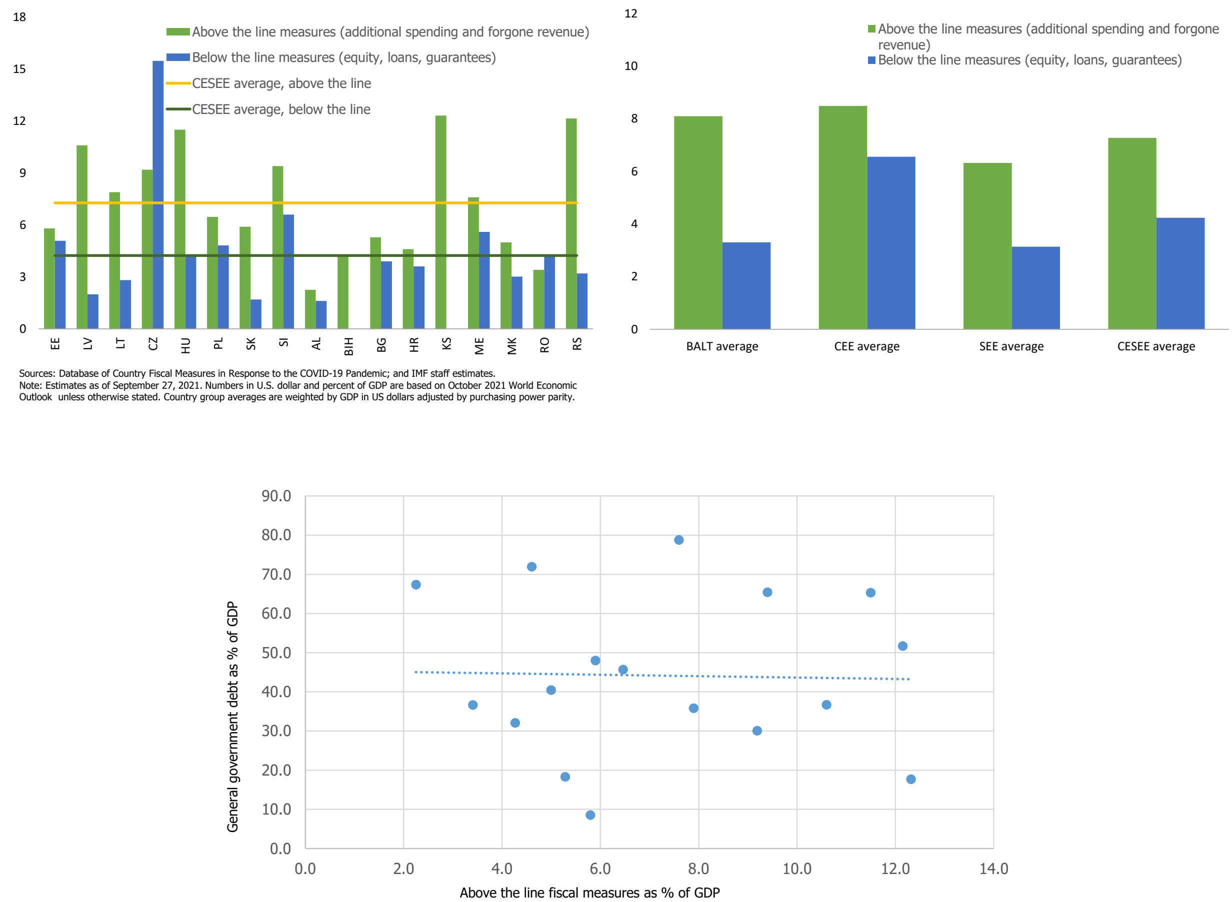
Fiscal Stance amidst Rising Risks and Interest Rates – the CESEE Perspective

Warnings on the side effects of "too low for too long" were proliferated, long before the central banking community started to tighten the policy stance to curb inflation. One of the alarms was the **possibility of excessive risk-taking**, of both the private and public sectors. The low interest rate environment was conducive to additional borrowing. In case of an abrupt tightening of financial conditions, or any other unforeseen shock, excessive leverage was considered a source of risk that could impact the capacity to repay debts, the overall risks profile, and ultimately the growth potential of the economy.

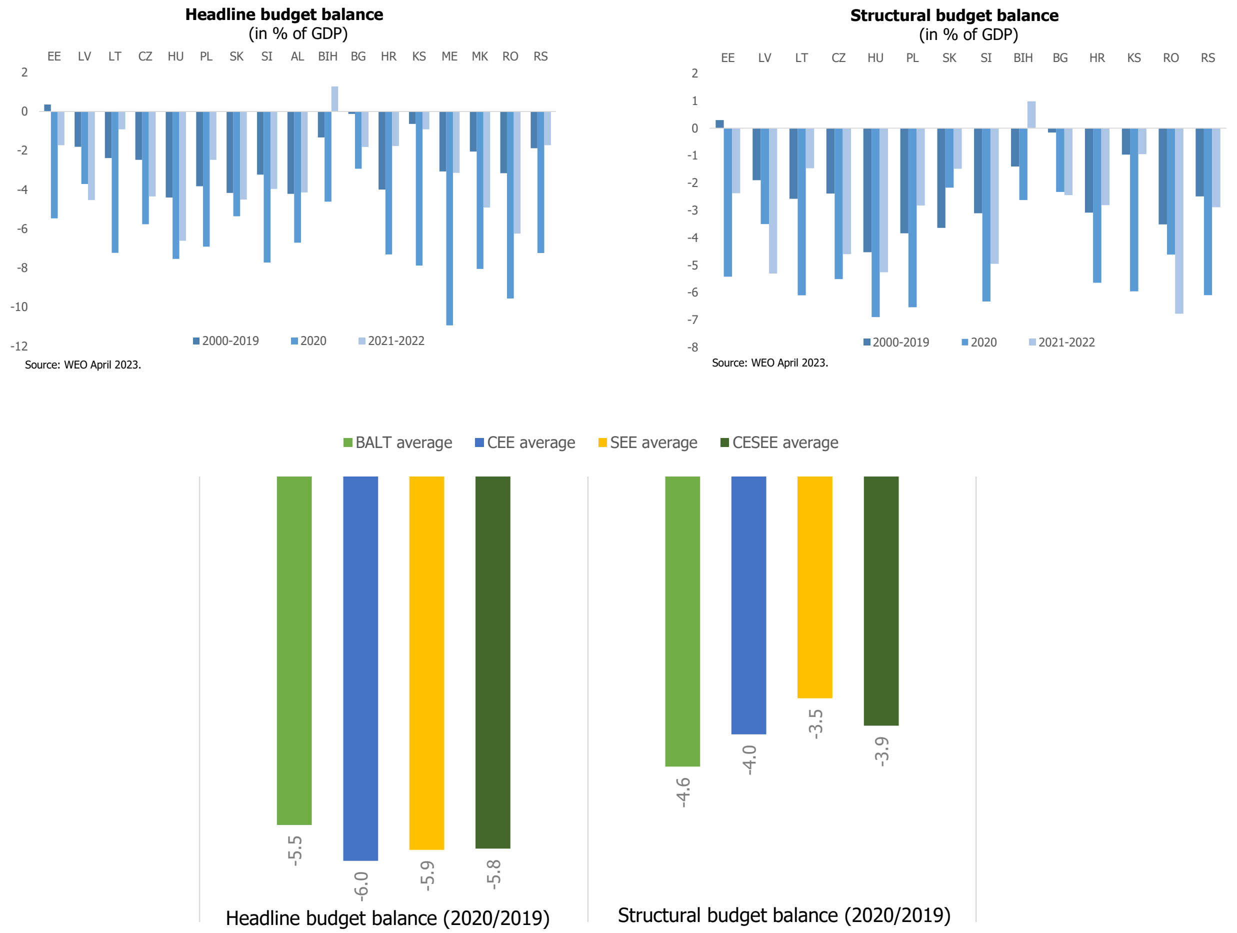
With regard to the fiscal profile, many of the potential risks came to the fore. First, it was the emergence of the pandemic. It prompted a strong fiscal response and interrupted the fiscal consolidation process. The overall global fiscal impulse through pandemic-related measures in only a two-year horizon (2020/2021) reached around 15% of GDP, referring to both above and below-the-line measures. There is a similar inference when the group of CESEE countries is observed, where the average fiscal response reached around 12% of GDP in total, although with large tails of the interval (from around 4% of GDP in Albania to close to 25% of GDP in the Czech Republic, mostly reflecting the high level of undertaken contingent liabilities). Given the specifics of the crisis and in line with the general recommendation that governments have to do whatever it takes to contain the damage to the economy, the size of the fiscal measures was not fully correlated with, nor dependent on the initial fiscal space and debt level. In other words, unprecedented fiscal stimulus was required in all countries around the globe regardless of their debt levels to sustain the well-being of the people and companies, which was brought to a standstill by the stringent lockdown measures. And borrowing was put at the disposal by a broad range of investors, even as countries' debt was transitioning towards historically high levels.

Figure 1. Discretionary fiscal response to the COVID-19 crisis in CESEE economies as % of GDP (top panel) and the relationship with the initial debt level (bottom panel)



Fiscal deficits rose rapidly with the outbreak of the pandemic. Consolidation took place afterward, but both headline and structural deficits remained elevated and above the pre-pandemic levels. On average for the region, the **structural budget deficit** reached 5% of GDP in 2020, compared to an average of 0.7% of GDP five years before the pandemic. It stabilized on average at 3.1% of GDP in 2021-2022, at a level that is still one of the highest in the last almost a decade. This indicates that not only the **cyclical position, but rather discretionary fiscal measures have not been rolled back to the extent that** will allow reversal to the pre-pandemic positions. Although the dispersion around the average is not large, still there are differences among different country groups, with the largest deterioration of the fiscal position in the Baltics, and the lowest in the SEE group.

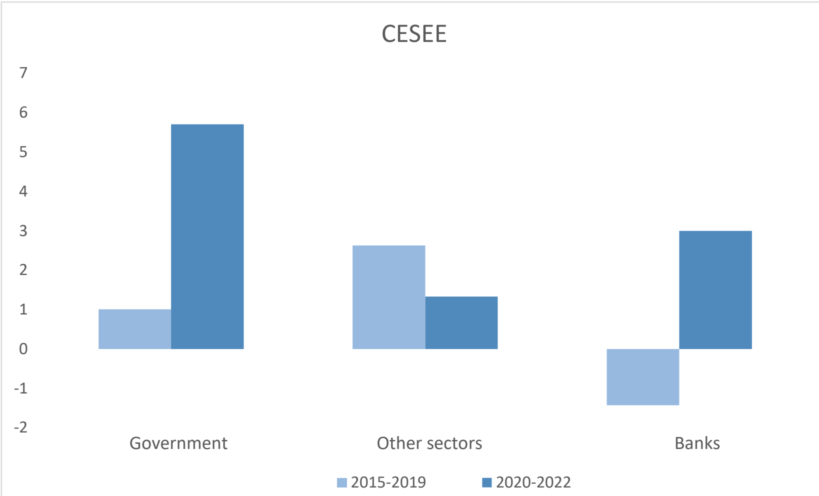
Figure 2. Headline and structural budget balance as % of GDP, in CESEE economies (top panel) and the change compared to the pre-pandemic level (bottom panel)



Source: Author's calculations based on WEO April 2023.

Conducive global financing conditions, with a decade of ample liquidity and low interest rates, supported the strong fiscal impulse. Previous scrutiny of the impact of low interest rates and strong quantitative easing in the euro area on capital flows in the CESEE group revealed that the largest impact was for the government borrowing, while private flows did not react much. During the pandemic crisis, as financing conditions loosened substantially, capital flows data reveal a similar pattern, with government flows being most responsive, on the backdrop of rising fiscal needs and low financing price. Cross-border financial flows reveal that during the 2020-2022 period, in this region, portfolio and debt liabilities flows related to government reached close to 6% of GDP, compared to only 1% of GDP, five years before the pandemic.

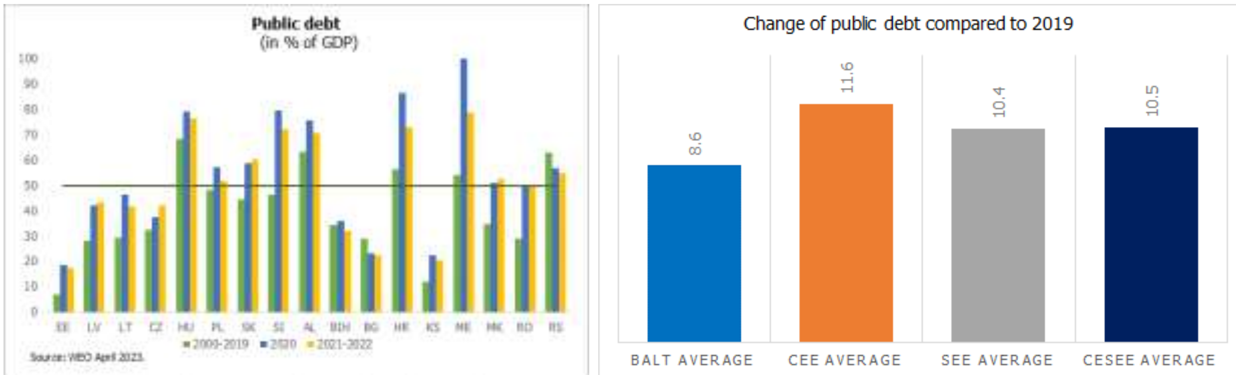
Figure 3. Capital flows in CESEE (% of GDP)



Source: Balance of Payments Statistics, IMF.

The confluence of rising fiscal deficit and benign global financing conditions resulted in a sharp increase in the government debt. In only one year it rose by close to 11 percentage points of GDP, and though declining somewhat it remains above the level pertinent to the period before the pandemic. Even before the shock, the public debt level was very close to some of the prudent thresholds - for instance the 50% of GDP, an IMF threshold for activating the "**high scrutiny" mechanism**. With the pandemic, the threshold was outpaced, and the current debt level is at par, on average in the CESEE region. However, some of the countries in the group are either close to or above thresholds, considered as **high-risk debt levels** and a threat to the scope for refinancing and market access (for example, Albania, Montenegro, Hungary, Slovenia, Croatia).

Figure 4. Public debt in CESEE countries

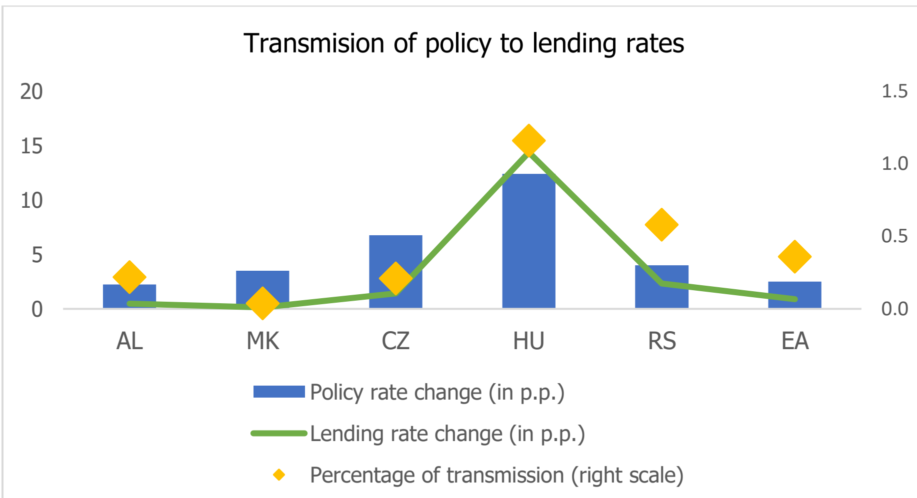


Overall, the pandemic left us with a much riskier fiscal profile, widened deficits and elevated debt levels, in some countries critically above the acceptable thresholds. The constrained fiscal space is nowadays facing another challenge, rising interest rates and much tighter financing conditions, as central banks are tightening their policy stance to tame inflation. Most central banks started their current tightening phase with a conventional 25 basis point increase in their policy rate. When inflation exhibited more inertia and became broader-based than expected, the magnitude of the tightening became more intensive. "The median interest rate hike quickly rose to 50 basis points and then to 75 basis points. From a historical perspective, two features of the current tightening episode stand out. First, it is the most synchronized tightening episode of the past 50 years. The percentage of central banks hiking rates has rarely been above 50%, and it reached 90% only during the global inflation surge of the 1970s. Second, central banks are generally raising policy rates at about twice their historical pace. In fact, for many countries the current cumulative increase in policy rates significantly exceeds that during the early stages of all previous tightening episodes" (BIS, 2022).

Figure 5. Global monetary policy conditions

That said, not only that the risk of tighter financial conditions became a reality, but an abrupt and aggressive rise in interest rates across the globe took place. From a private-public perspective, the transmission of the shock was immediate for sovereigns. As much of the financing for the private sector comes from domestic banks, lending interest rate data reveals that not in all countries, transmission was full, but it is rather more gradual allowing some time for the private sector to adjust to the higher interest rate environment.

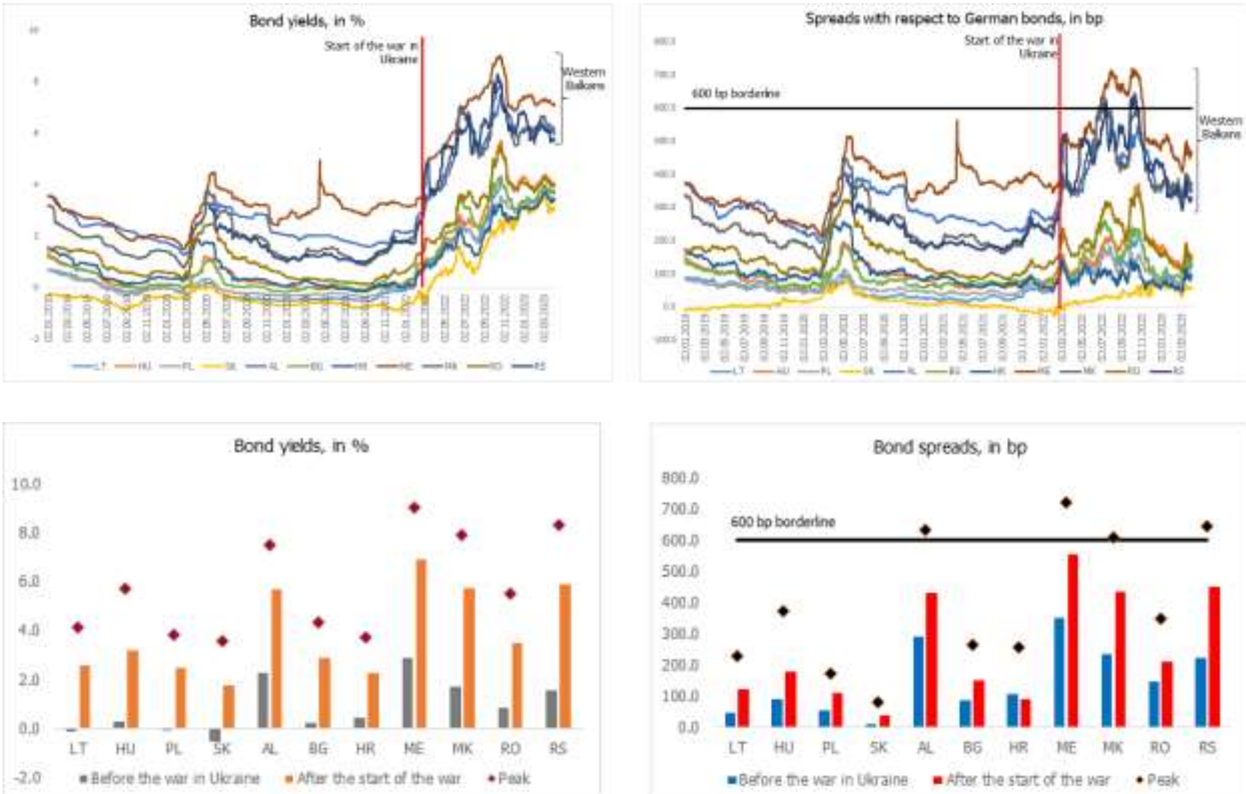
Figure 6. Change of the policy rate versus the lending rate



Source: Author's calculations.

On the other hand, the "**punishmen**t" for **the government on the international markets was swift and strong**. **As a combined effect of monetary tightening and rising risk premiums against uncertainty, government bond yields increased significantly.** For most of the CESEE countries yields already peaked in October last year, whilst for some of them (especially the Western Balkans countries) the spreads towards the less risky bonds (the German bonds for instance) reached or even briefly surpassed **the level of 600 basis points, which is considered as a borderline for high risk in terms of market perceptions.** Yields stabilized since then, but on average, they remain close to 300 basis points higher, in comparison with the point before the war in Ukraine.

Figure 7. Bond yields and spreads in CESEE



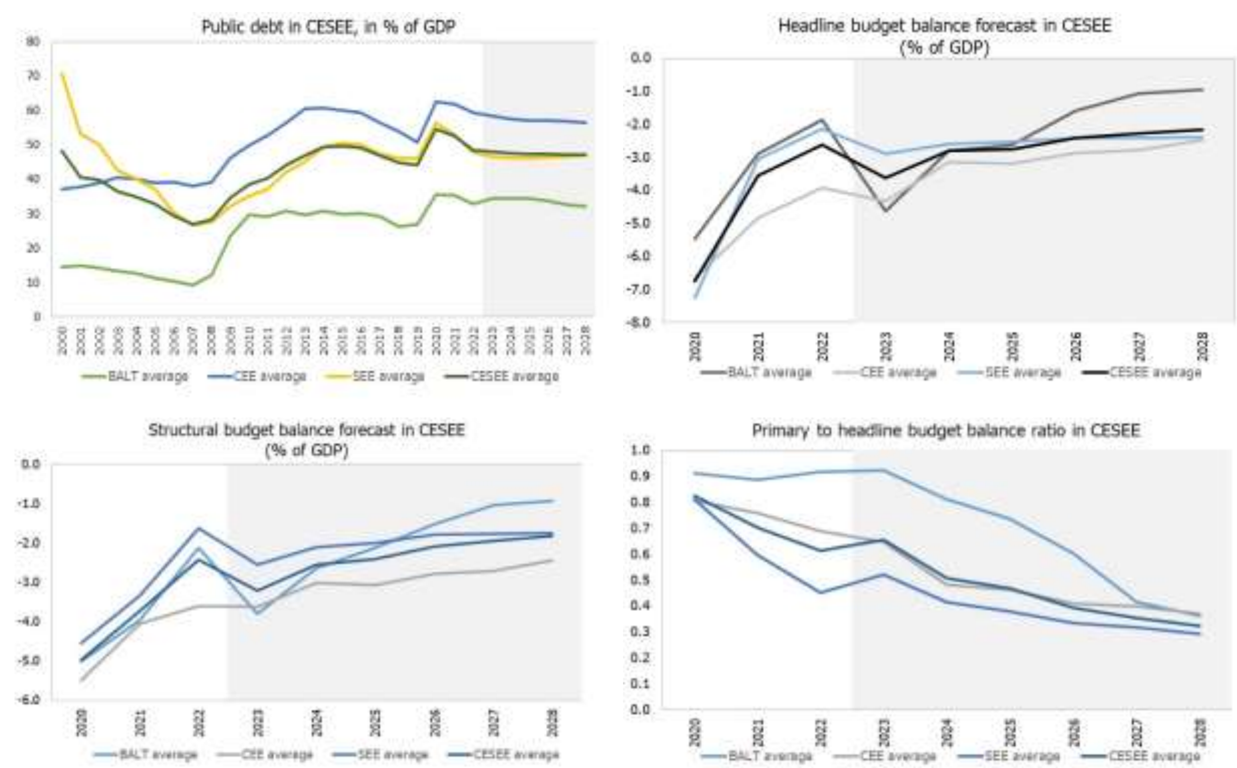
Source: Bloomberg and author's calculations.

In summary, fiscal authorities in the region are caught by a combination of adverse forces. Tightening of financial conditions, with rising rates and less global liquidity, strong volatility on financial markets and uncertain growth prospects. The mix of all the risks and the already deteriorated fiscal profile requires a focused and credible fiscal consolidation process. This will alleviate the burden on the financing needs and the pressure on refinancing costs and will ensure easier access to international financial markets. **In a nutshell, consolidation is needed in order to ensure a sustainable debt position.**

The concept of debt sustainability is a rather complex one, as it involves the future perspective of fiscal flows, as well as the need to test the baseline scenario against different stress tests. How does the baseline scenario for the fiscal position of the region look like? The latest estimates envisage a mild reduction of the debt level from 48.6% of GDP in 2022 to 47.1% in 2028, which means that the debt level will not reverse to the pre-pandemic one. For the CEE and SEE groups, the debt level remains in the medium run not far away from some of the warning thresholds. **Hence, fiscal risks will remain elevated in the**

medium run, while accompanied by much more uncertainty than before. The data point to a **temporary fiscal consolidation in 2021-2022, as in 2023 deficit is expected to** spike again, before stabilizing somewhat above 2% of GDP. **The ratio between the headline and the primary deficit is expected to widen somewhat in 2023, indicating a larger interest rate burden amid risings costs of financing, and to follow a declining trajectory afterward.**

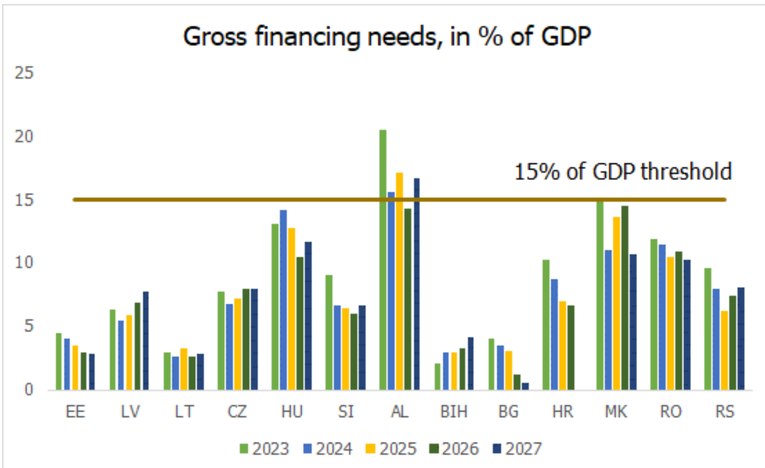
Figure 8. Public debt and deficit forecasts in CESEE



Source: WEO April 2023.

The higher interest rate and lower liquidity environment pose challenges to refinancing, particularly for those countries where fiscal gross financing needs are elevated. The scrutiny of the latest available data shows that, on average the exposure of these groups of countries to this risk is rather contained. Gross financing needs, defined as the sum of the expected deficit, the short-term debt to be refinanced and the medium and long-term debt repayment due within the year, on average are expected to hover around 8% of GDP in the time frame 2023-2027. This is much lower, as compared to the IMF benchmark of 15% of GDP – the threshold for a high-risk zone. Still, there are some exceptions within the group. This especially refers to Albania, where the financing needs are almost continuously above the high-risk threshold.

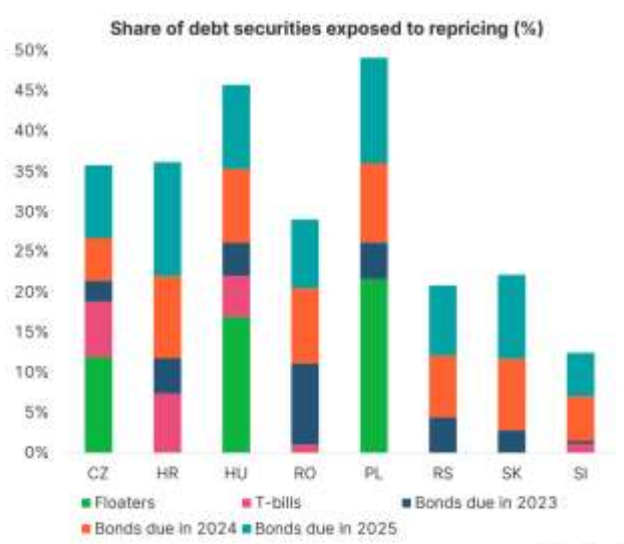
Figure 9. Gross financing needs in CESEE



Source: IMF Article 4 Reports.

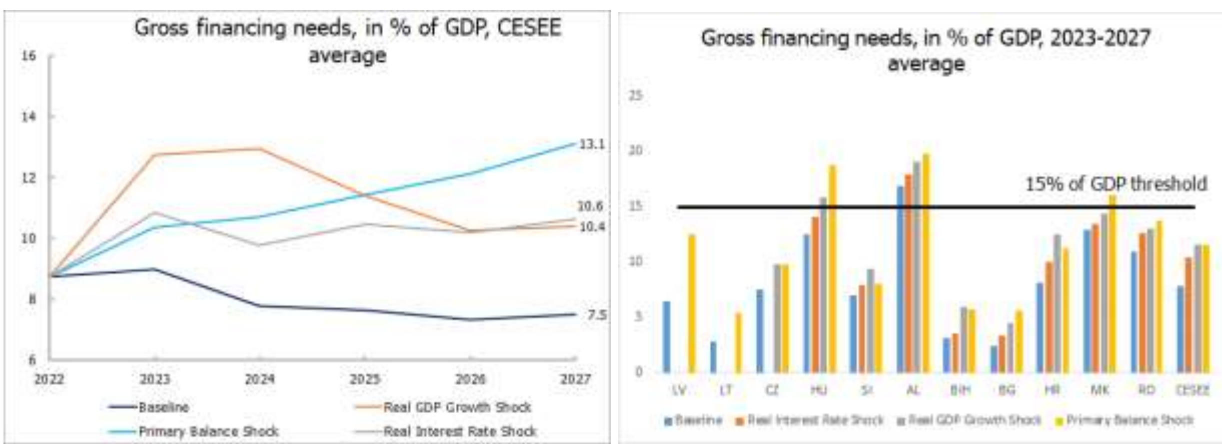
However, to obtain a clearer view of the effects of the higher interest rate environment one must also take into consideration the composition of the debt securities exposed to repricing in the medium term. In this regard, some CEE countries are more exposed to higher costs than others are. For example, by 2025, 45-50% of Hungary and Poland's current outstanding debt will be repriced or rolled over at market rates, as opposed to only 12% in Slovenia. Moreover, Hungary and Poland are the most exposed countries in CEE to rising borrowing costs also due to the high shares of floating-rate securities in outstanding debt instruments.

Figure 10. Composition of debt securities due in the medium term



Given the extreme uncertainty pertinent to the current context, the baseline scenarios are not sufficient tools to assess the position. Stress tests and scenario analysis are also important in order to have a more comprehensive view of the main sources of risks that we should be mindful of. The most prevalent risks relate to **slower growth, less fiscal consolidation**, as well as **tighter than envisaged financing** terms. Based on the latest available IMF Debt Sustainability Analysis (DSA) for the region, **the public debt level** in several countries (Albania, Croatia, Hungary) is sensitive to all types of shocks, being positioned in the red zone, meaning that it exceeds the threshold of 70% of GDP. There is a similar case with gross financing needs that enter into the red zone, after stressing the baseline scenario with different assumptions. **The refinancing is particularly sensitive to shocks in growth and unchanged fiscal stance. If these shocks are to occur, the 2023-2027 average gross financing needs rise from close to 8% of GDP in the baseline to close to 12% of GDP.**

Figure 11. Gross financing needs in CESEE under different stress test scenarios

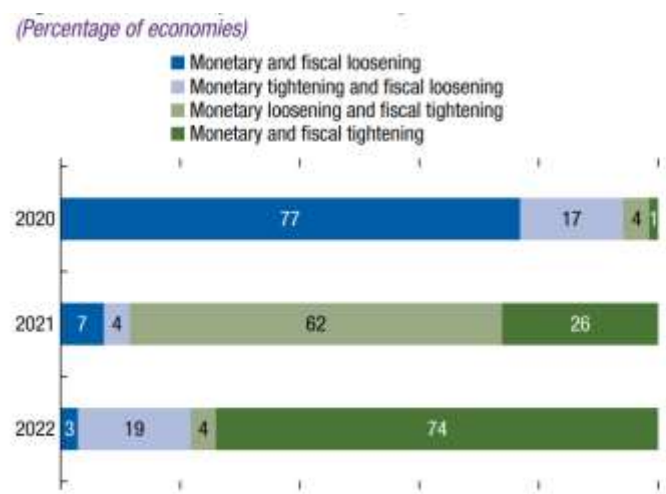


Source: IMF Article 4 Reports.

Overall, fiscal policy should enter into normalization mode, reducing or stabilizing debt levels and rebuilding fiscal buffers. This requires commitment to ambitious fiscal consolidation plans, in order to stabilize or decrease debt levels. In times of great uncertainty, "medium-term fiscal policy **should be anchored by debt sustainability objectives** and **build up sufficient fiscal buffers over time,** consistent with the expanded role of fiscal policy in times of crises. In other words, there should be a **greater focus on risk assessment**, as it will encourage "incentives to build up buffers over time, even when there is no immediate high risk of debt distress" (IMF Fiscal Monitor, April 2023).

The need for a prudent and risk-based fiscal stance is even more accentuated in the current inflationary environment, when the tightening of monetary policy should be supported by fiscal tightening as well. The disinflationary impact of fiscal policy can be observed through the **direct channel, by trimming the overall demand,** but also through **indirect channels,** by providing additional credibility to the overall macro-policy mix. If not supported, central banks, in the end will deliver over excessive real interest rates that can harm the overall economy and the debt dynamics as well. So far, since 2021 fiscal policy globally seems supportive of the disinflationary monetary policy stance. **The mix of tighter monetary and fiscal stances is prevailing globally.** Recent estimates by the IMF show that a 1 percent-of-GDP rise in government spending, results in an average increase in inflation of roughly half a percentage point, and flattens out after three to four years, and vice versa. **This indicates that keeping the fiscal consolidation on track could be supportive of central banks' disinflationary efforts.**

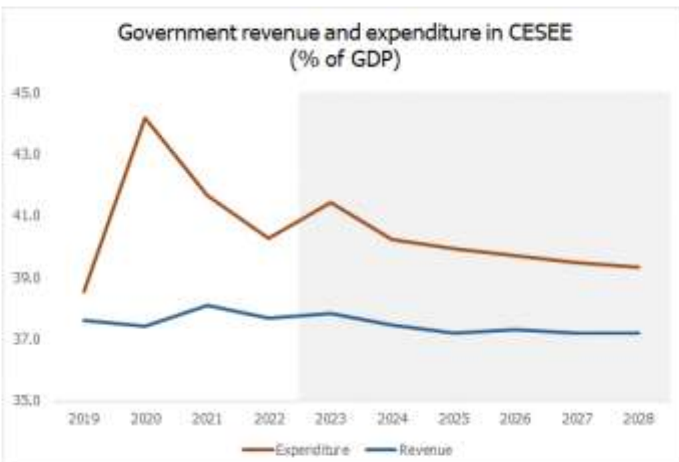
Figure 12. Global monetary – fiscal mix



Source: IMF Fiscal Monitor, April 2023.

The latest inflationary episode, driven by a confluence of commodity price shocks and pandemic-related disruptions was accompanied by a handful of different fiscal measures as a temporary price relief. Governments are preventing corporate bankruptcies through temporary transfers, protecting companies and households from price shocks. Most of the measures were directed toward curbing pass-through to final prices and controlling inflation. Yet, these are only palliative solutions, as long-term solutions relate to productivity and efficiencyenhancing measures, rather than providing temporary relief through price-distorting measures. **Many studies reveal that inflation suppressing fiscal stance requires compression of fiscal spending. In case of a cost of living crisis, this policy should be accompanied by only targeted measures for the vulnerable, through the fiscal distributional role.** As for the region, the latest assessment **reveals that the envisaged fiscal consolidation is to be expenditure-based,** as the most efficient disinflationary tool. Total expenditures are expected to decline by around 2 percentage points of GDP from 2023 until 2028, providing support to the disinflationary mission of the monetary policy. The adjustment from the peak in 2020 is close to 5 percentage points.

Figure 13. Fiscal consolidation in CESEE



Source: WEO April 2023.

Summary

Albeit there is heterogeneity among countries, in general fiscal positions in the region, as well as globally are under strain. The pandemic has absorbed the fiscal space and urged the need for replenishment of fiscal buffers. The war in Ukraine and the subsequent energy and food crisis, created additional pressure on public finances, as measures were introduced to protect corporates, and vulnerable households, and to prevent second-round effects on final prices. Thus, fiscal consolidation was interrupted and deficits and debt levels are envisaged to remain above the pre-pandemic levels. The fiscal strains are additionally strengthened by the much higher interest rate environment than before. Amidst elevated uncertainty, stress tests reveal particular sensitivity of the debt level and financing needs to the potential absence of the planned fiscal consolidation. Therefore, a strong and credible build-up of fiscal buffers must be in place. Even more in the presence of elevated inflation risks that require fiscal support for the monetary tightening.

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