

Special Report

– February 18, 2010

Fiscal situation in CEE countries

Governments in the CEE region are far less indebted compared to Euro Area average

CEE countries started their homework earlier

The liquidity surplus on local markets is supportive of a further decline of CEE yields

Strictly required sustainability may delay euro adoption to 2015-16 in CEE (ex-Estonia)

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How big is the public debt in CEE?

ECB exit will increase pressure on financing of deficits

Mounting public debts and potential difficulties with their financing has become a big worry in Europe. The European Commission warned already in autumn that countries that do not present reliable consolidation plans and take measures will face increased borrowing costs. The market reaction might accelerate after the ECB exit from non-standard measures; these allowed governments – via huge liquidity supply to financial institutions - to finance their deficits easily at exceptionally low costs last year. Generous liquidity supply helped to stabilize the financial sector and smooth the economic adjustment, but at the same time it masked the problem of rising fiscal deficits and their financing.

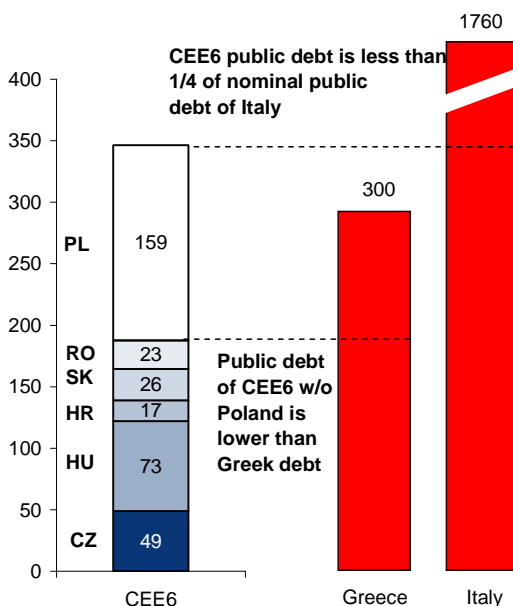
Public debt of CEE6 is less than a quarter of Italy's public debt

Now many governments in the EU have to pay the bill for the fiscal loosening and are supposed to deliver austerity measures that can slow down the economic recovery (or even deeper recession). The public debt of CEE6 countries¹ is much lower both in nominal and relative terms (as a share of GDP) than in Euro Area countries. The public debt of these CEE6 countries ex-Poland is about EUR 200bn in total, which is less than the public debt of Greece, with an estimated public debt of EUR 300bn. If we add Poland, the largest country among the new member states, the public debt of the whole CEE6 region would be below EUR 400bn - still less than in Spain (estimated at EUR 700bn) and less than a quarter of the public debt of Italy (estimated at EUR 1,800bn).

Apart from Hungary, debt ratios are well below the Euro Area average

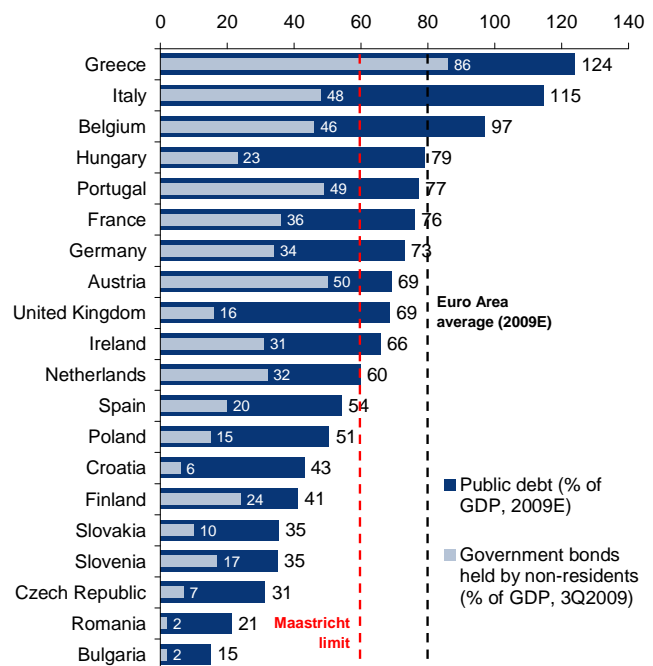
The public debt of CEE countries is much lower also in relative terms to GDP. From the CEE region, apart from Hungary, all CEE countries have kept their public debt below 60% of GDP. Hungary's public debt is estimated at about 80% of GDP for 2009, exactly the Euro Area average level. The share of government securities held by non-residents (which might speed up the sell-off) is relatively low. While about 2/3 of Greece's public debt (90% of GDP) is held by non-residents through investment in Greek government bonds, in CEE6 it is about 1/4 (2-23% of GDP)

Nominal public debt (2009E, EURbn)



Source: AMECO, Erste Group Research

Public debt (% of GDP, 2009E)



Source: AMECO, JEDH, Erste Group Research

¹ We deal in this report with six CEE countries - Poland, Hungary, Czech Republic, Slovakia, Romania and Croatia.

What is the reason for the widened deficits in CEE?

In 2007, a year before the global recession started, CEE6 countries were running a fiscal deficit of 2.4% of GDP, on average, lower than Portugal, the UK, France or Greece at that time. Only Hungary exceeded the 3% ceiling required by the Growth and Stability Pact, with a deficit at 5% GDP. In 2009, fiscal deficits ranged between 3.0% and 7.4% of GDP in CEE6, well below France, Portugal, Ireland, Greece, Spain and the UK (which were in the 8-12% range, according to European Commission estimates from autumn 2009).

Good years were not used for deeper consolidation

The recent widening of fiscal deficits in CEE6 can be seen in two dimensions. The first one is that these countries have not taken advantage of the good years to push their deficits even lower during the economic boom. High economic growth boosted tax revenues, enabled higher growth of expenditures and masked growing structural deficits during 2005-07. Thus, despite the headline deficit being below 3% of GDP in 2007, cyclically-adjusted deficits stayed above 3% or even grew to 4-5% of GDP (Slovakia, Romania) at that time.

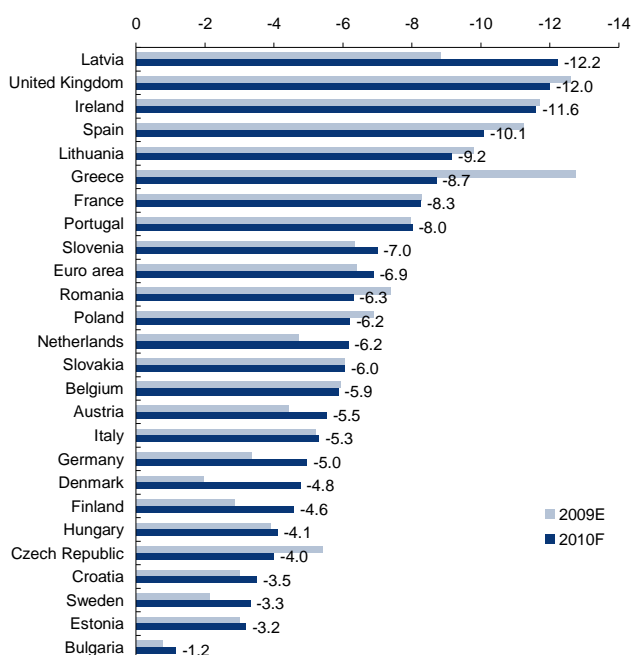
Late actions led to further deterioration of structural deficits

The sharp economic deceleration has reversed the cyclical component of government balance from positive to negative and unveiled high structural deficits. On top of that, governments were too late in revising the budget and aligning the budgeted growth of expenditures with the changed macro assumptions. This resulted in further deterioration of structural deficits in all countries except Hungary and Romania, countries that, under the IMF program, had to take prompt action and closely monitor growth of expenditures.

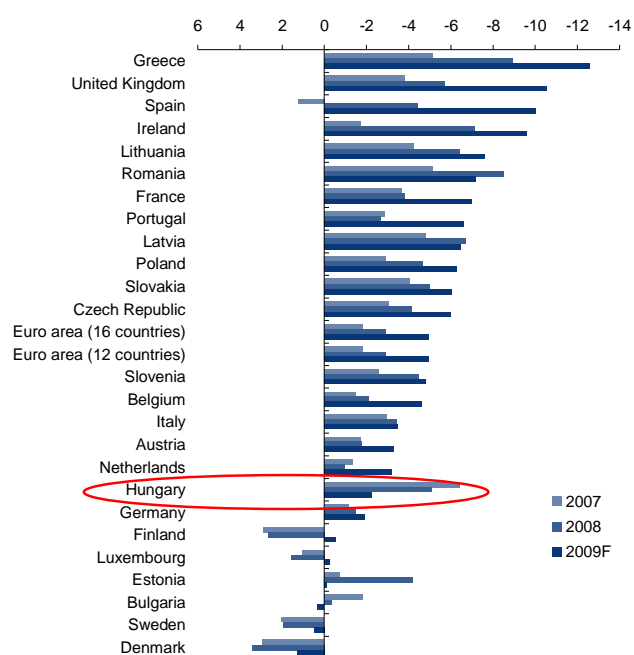
Slovakia and Poland are lagging in consolidation

Countries that had not been under financing pressure could afford a more laissez-faire approach and let deficits grow practically without any action (Slovakia, Poland). Given the 'temporarily relaxed' Growth and Stability Pact, it became unpragmatic for governments approaching elections in 2010 to rush for fiscal consolidation already in 2009, bearing in mind that countries subject to the Excessive Deficit Procedure have to consolidate another (at least) 0.5pp in 2010.

Fiscal balance (% of GDP)



Cyclically-adjusted balance (% of GDP)



Source: AMECO, Convergence Programs, Erste Group Research

Source: AMECO, Erste Group Research

What have countries done to reverse the negative development in public finances?

Hungary is the most successful frontrunner in fiscal consolidation

The first country to react promptly to the crisis was Hungary. The strong sell-off of Hungarian government bonds by non-residents shortly after Lehman's collapse paralyzed the bond market and forced Hungary to seek international assistance. Hungary had to make commitments on further reduction of its deficit, while disbursement of financial aid has been conditional on achieving certain goals. This mechanism was proven to function properly and Hungary delivered a wide set of austerity measures on both the revenue and expenditure sides. The increase of the upper VAT rate by 5pp to 25% was the boldest tax hike in the region.² At the same time, Hungary reduced social contributions and personal income tax in order to support the labor market and motivate people to work officially. Another brave move was an increase of the retirement age and change in indexation of pensions. On top of that, extra pensions and bonuses for the public sector were canceled and various subsidies cut. Hungary managed to cut its fiscal deficit from 9.4% to less than 4% of GDP in three years, despite the sluggish economic growth and being hit hard by the global economic crisis.

Romania delivered the second round of measures early this year

Other countries were not so eager to consolidate. Romania, which asked the IMF for assistance later, adopted only mild measures compared to Hungary in the first round. So far, Romania avoided hiking the VAT or personal income tax, but it introduced a minimum corporate tax linked to turnover that aimed to reduce tax evasion. After the presidential election (which broke the political deadlock), they agreed on a second round of measures that kept them on track with the IMF early this year. The core measures consist of downsizing of personnel costs in the public sector, cutting other non-mandatory expenditures, as well as some structural changes, like revision of the pension law (including gradually lifting the retirement age to 65).

VAT hikes – the most reliable way to increase revenues

Croatia had to act promptly in 2Q09 to avoid a lack of confidence ahead of their external borrowings. If they had not succeeded, they would have needed to ask for external assistance as well. Croatia focused more on tax increases, hiking the VAT rate by one percentage point, introducing extra personal income tax for the high income bracket and increasing property taxes. The Czech Republic increased indirect taxes (including the VAT by 1pp) and lifted the base for the calculation of social contributions, but was relatively hesitant to touch expenditures. Poland and Slovakia have done a little to reverse the negative fiscal development in 2009. Slovakia decided not to index the tax-deductible part of income and hiked excise taxes on alcohol, while a cut of capital expenditures was scheduled for 2010.

Measures already adopted in 2009/10

	Direct taxes	Indirect taxes	Social contributions	Pensions and public wages	Other expenditures
CZ		+1pp on VAT increased excise and property taxes	Increased cap on the base for calculation	some social benefits were cut by 15%	
HU	Reduced personal income tax, replaced solidarity tax, intr. of super gross wage	+5pp on VAT	Social security contributions paid by employers were cut to 27% from 32%	13th pensions and bonuses canceled, new rules for pension payments	Exp. cuts: public transport, local councils, energy subsidies, home subsidies
HR	extra personal income tax introduced (+2%/4%)	+1pp on VAT excise duties on telecom services		public sector wages brought back to 2008 levels	
PL	reduction of personal income tax (18-32% instead of 19-40%)				
RO	minimum corporate tax introduced	increase of excise taxes, increase of property taxes	3.3pp increase in the rate	new rules for pension payments, gradual increase of retirement age to 65	Exp. cuts: purchases of goods and services
SK		increased excise taxes			central government expenditure cuts for 2010 (especially capex)

Source: Erste Group Research

² Greece, which is now in deep fiscal trouble, has avoided hiking its VAT rate (4.5/9.0/19.0%) so far. However, an increase of indirect taxes is the most reliable way to narrow the deficit in the short run.

How much do CEE governments have to borrow this year?

Given the much lower level of outstanding public debt and fiscal deficits of CEE economies compared to Euro Area countries, borrowing in the former will be much lower. The Czech Republic, Slovakia and Romania will benefit from their low levels of debt and the consequently lowest volumes of maturing debt (of about 4-5% of GDP) to be revolved. Poland, Croatia and Hungary need to refinance much higher volumes of maturing government securities, worth about 8-10% of GDP.

Financing from IFIs might reduce the issuance of government securities in Hungary

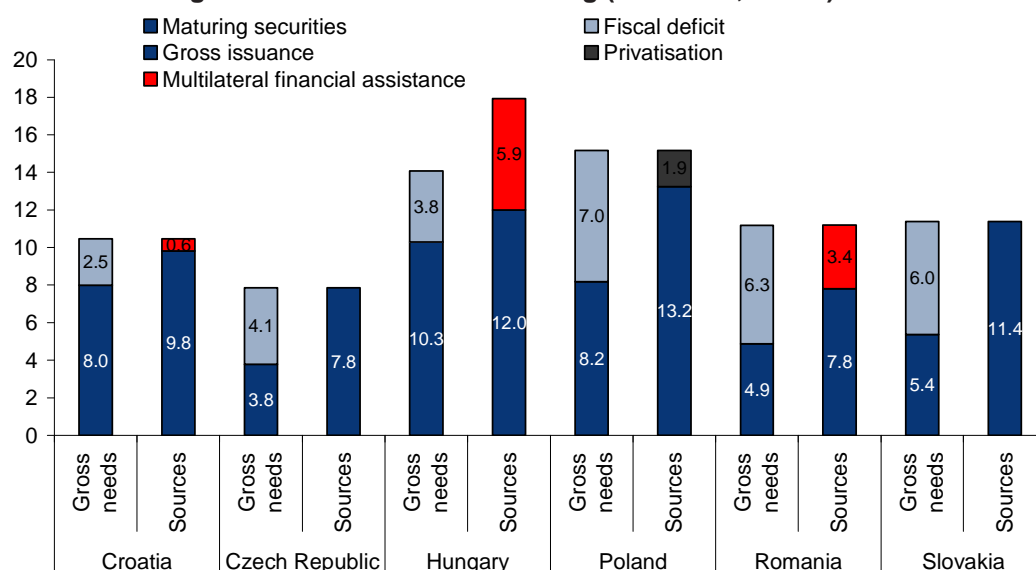
Despite its relatively high volume of maturing government debt, Hungary will likely maintain the gross issuance of government securities at a favorable level close to that of their CEE peers (8-13% of GDP). The reason is that the country has one of the smallest deficits in the EU (below 4% of GDP in 2010) and a large cushion of funds from IFIs (6% of GDP), which, if drawn in full, would lead to a negative net issuance of government securities. However, the Hungarian debt agency has announced that their primary goal is to borrow on markets and rely on IFIs only in the case the markets dry up.

Poland, with the second largest amount of maturing debt in the region and one of the highest fiscal deficits in the CEE region, would face a massive supply of government securities and an increased level of public debt. However, Poland's public debt is approaching the critical level of 55% GDP, which - according to the constitution - triggers automatic stabilizers for halting further debt growth. That is why the Polish government decided on a privatization plan that should reduce debt financing needs by 2% to about 5% of GDP (13% of GDP gross).

Romania will likely have the lowest issuance of securities

The Romanian government, the least indebted in the region, with public debt at 21% of GDP (a quarter of the EU average), will together with the Czech Republic and Slovakia have the lowest gross issuance of government securities. If the Romanian government decides to use the financing from IFIs more extensively to finance the government debt, the gross issuance of government securities will certainly be the lowest in the region (less than 8% of GDP).

Gross financing needs and source of financing (% of GDP, 2010F)



Source: Ministries of Finance, Erste Group Research

Who will buy the CEE6 government debt?

Subdued credit growth supported demand for bonds

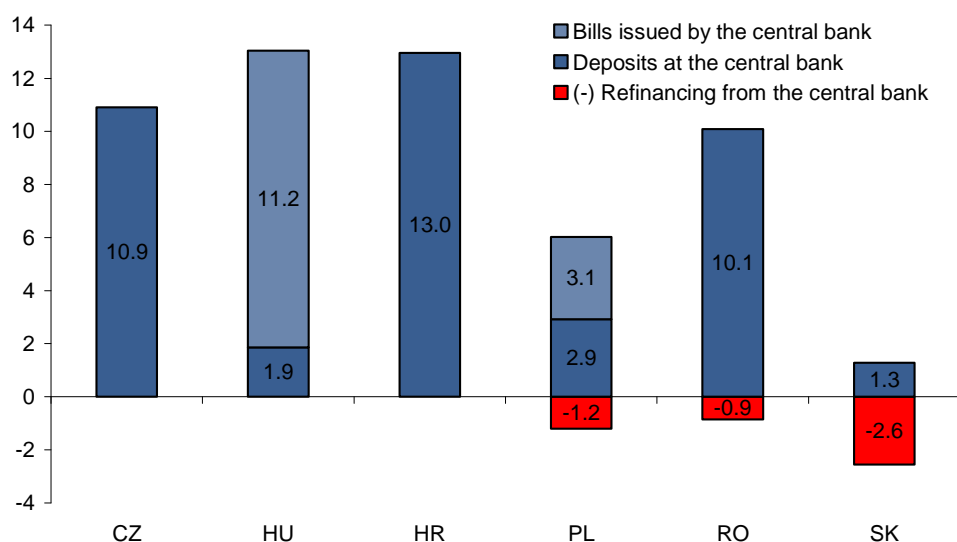
The global financial crisis has led to increased demand for government papers, which helped governments finance their deficits relatively cheaply. As credit growth has been decelerating or even shrinking, and deposits have been rising, excessive liquidity has supported government bonds. As no strong rebound of credit demand is expected this year (especially on the corporate side), banks will continue to invest a big proportion of increased deposits in government securities. The net demand of local banks for government securities stemming from the change of customer deposits and loans should total up to about 1% of GDP.

Liquidity surplus on CEE markets should keep the local demand strong

In the Euro Area, demand for government bonds was artificially increased by cheap refinancing from the ECB and the occurrence of opportunistic carry trades. This has not been the case for CEE6 banks³, as additional liquidity from the central banks has been close to zero. Moreover, the CEE6 banks (ex-Slovakia) sterilize a huge amount of liquidity in central banks, which they can invest in government securities if the credit growth remains subdued and short-term rates are at a low level. Hungarian and Czech banks do not refinance from central banks; deposits at central banks or central bank bills total about 1/10 of their assets (or 11% and 13% of GDP, respectively). The net sterilization position of Romanian and Croatian banks is also very high (9% and 13% of GDP, respectively), but a big proportion of deposits in central banks is related to minimum reserves requirements. Both central banks are very likely to continue in further monetary easing, also through cutting of minimum reserves requirements⁴, which will unfreeze the liquidity and might increase demand for government securities.

Aside from banks, demand for government securities from local pension funds, insurance companies and mutual funds is to total about 0.5-2.0% of GDP in 2010. Poland managed to issue Eurobonds early this year and it is very likely that the Czech Republic, Hungary, Romania, Slovakia and Croatia will approach international markets too, which should ease the situation on the local bond market.

Sterilisation position of CEE banks vs. central bank (% of GDP, 2009E)



Source: Central banks, Erste Group Research

³ This is not the case in the Slovak banking sector, which, after the country joined the Euro Area, transferred its former deposits from the central bank into government securities, refinancing via the ECB and buying government securities.

⁴ The National bank of Romania cut MMR a couple of times in 2009; Croatia's central bank cut MMR in February; the Polish National Bank cut in July 2009 (from 3.5 to 3.0%).

When can countries meet the Maastricht criteria on fiscal deficits and public debt?

Apart from Bulgaria, Estonia, Sweden, Denmark, Luxemburg and Finland, all EU member states are in the Excessive Deficit Procedure (EDP), meaning they do not meet the Maastricht criteria. Early this year, EU countries delivered their convergence programs to the European Commission, outlining the correction path of their public deficits. Already in autumn, the European Commission postponed the deadline for the correction of excessive deficits for many EU members, except for Greece, where the fiscal situation was alarming. The European Commission recommended that Euro Area countries use 2010 for stabilization of their deficits and preparing austerity measures for the beginning of 2011, at the latest. EcoFin was concerned that the earlier withdrawal of fiscal stimuli endorsed by the European Economic Recovery Plan (EERP) might undermine the fragile recovery of the EU.

Less painful consolidation, thanks to earlier start

Given the fact that the deficits of CEE countries are lower than the Euro Area average and that these countries started earlier with consolidation (mid-2009 and the beginning of 2010⁵), their consolidation will be more achievable and less painful than in Euro Area countries. According to its convergence program, Hungary is to cut its deficit to below 3% by 2011. Poland and Romania should correct their excessive deficits by 2012, the Czech Republic and Slovakia by 2013. The former two will need to consolidate their deficits by almost 2 percentage points per year from the 2009 level in order to meet their goals by 2012.

Strictly required sustainability may delay euro adoption to 2015-16

We see it as more realistic that, on top of curbing headline fiscal to below 3% of GDP, the European Commission will pay more attention to the fulfillment of Maastricht criteria in 'a credible and sustainable manner'. This means that candidate countries will likely be asked to fulfill the criteria with a wide margin and/or keep their deficit below 3% of GDP for a longer period of time (not just at one point in time) before positive assessment. The European Commission might also require structural deficits to be below 3% of GDP⁶ and structural reforms to be put in place (healthcare reform, pension reform), which should reduce the vulnerability of public finances to longevity. This would mean a positive evaluation of Maastricht criteria at least one year after the deficit is reduced to below 3%, which might delay euro adoption to 2015-16⁷ for CEE countries (ex-Estonia).

Euro adoption timetable under implicitly stricter rules (estimates)

	2010	2011	2012	2013	2014	2015	2016
CZ				●	●	●	●
HU				ERM-II		●	EUR
HR				ERM-II	●	●	EUR
PL			ERM-II		●	EUR	
RO			ERM-II		●	EUR	

● - Maastricht criteria fully met

Source: Erste Group Research

⁵ Hungary started with consolidation already in 2007 after the fiscal deficit reached 9.3% of GDP in 2006.

⁶ Slovakia would not have qualified for the euro if the adjustment of the deficit for the cyclical component had been considered during assessment.

⁷ Estonia is likely to adopt the euro in 2011, also thanks to historically low deficit and public debt.

Are public finances in CEE sustainable in the long run?

On top of short-term measures, CEE economies have to deal with a new challenge – their ageing and shrinking populations in a horizon of 40 years. Lower fertility rates and rising longevity in CEE might increase the old-age dependency ratios from the currently low level of 17-21% towards an estimated 55% by 2050. Growth of ageing related expenses will require some structural reforms in the pension system and healthcare.

Hungarian and Romanian governments have already started to deal with structural reforms

Recently, the Hungarian and Romanian governments decided to gradually increase the retirement age to 65, which is currently the standard level in the EU. The Czech Republic already has the gradual increase of the retirement age to 65 for men and 62-65 for women (depending on the number of children) in place. Some EU countries that have dealt with longevity for a longer period of time have already scheduled an increase of the retirement age to 67-68 (Germany, Denmark, Finland, the UK) in the next 2-3 decades. Polish politicians have started to discuss an increase of the retirement age to 67, from the current 64-65. Slovakia, which faces one of the sharpest demographic changes, has been the only country in the region hesitant to increase the retirement age to above 62 years so far.

In addition to the adjustment of the retirement age, some other parametric changes are necessary for pension schemes. The Romanian government focused on extending the timeframe from which the pension is derived for certain categories of employees⁸. Also, a change of indexation of pensions down to inflation from any linkage to average nominal wage growth might help to stabilize the growth of expenditures on pensions. Demographic challenges might lead to a higher importance of taxation of consumption (increase of indirect taxes) over taxation of income.

The quality of public discussion on public finances has been improving in recent years. Last year, the Fiscal Council was established in Hungary and a similar body should be created in Romania through the fiscal responsibility law, which should be approved in March. Recently, the Slovak National Bank presented a proposal for establishing an independent fiscal watchdog. Poland has a constitutional law that restricts the deficit and growth of expenditures once the public debt reaches one of two limits (50% and 55% of GDP) defined by the public finance act. The third (constitutional) limit is set at 60% of GDP. After exceeding 60%, the government has to present a balanced budget – a commitment device for the government - and limit future issuance. By now, 50% was likely breached in 2009. The government's debt management strategy for 2010-12 projects public debt in the coming years at just a hair below the 55% limit (given the uncertainties, this line could be crossed)

⁸ It was common in Romania that the last salary gains before retirement were artificially inflated in order to increase pensions.

Rating upgrades and downgrades

Rating upgrades for Hungary and Romania are in the pipeline

Hungary was downgraded by up to two notches during the crisis and Romania lost its investment grade from S&P and Fitch. However, the brisk adjustment of their external imbalances (particularly current accounts) and encouraging consolidation efforts might lead to upgrades for these countries. In Hungary, it is more likely to happen only after the elections, i.e. if the new government sticks to the ongoing consolidation plan. An upgrade of Romania is contingent on the effective implementation of all of the fiscal consolidation measures announced by the government in 2010. Given the risk that some Euro Area economies might fail to meet their ambitious fiscal consolidation targets, the gap between ratings of western and CEE economies might shrink in the coming years.

Sovereign country ratings

S&P			Moody's			Fitch		
	current rating	before the crises		current rating	before the crises		current rating	before the crises
AAA			Aaa			AAA		
AA+			Aa1			AA+		
AA			Aa2			AA		
AA-			Aa3			AA-		
A+	SK		A1	CZ, SK	CZ	A+	CZ, SK	CZ
A	CZ	CZ, SK	A2	PL	PL, HU	A		SK
A-	PL	PL	A3			A-	PL	PL
BBB+		HU	Baa1	HU		BBB+		HU
BBB	HR	HR	Baa2			BBB	HU	RO
BBB-	HU	RO	Baa3	HR, RO	HR	BBB-	HR	HR
BB+	RO		Ba1			BB+	RO, TUR	
BB			Ba2	TUR		BB		
BB-	SRB, TUR	TUR	Ba3		TUR	BB-	SRB	UA, SRB, TUR
B+		UA	B1		UA	B+		
B			B2	UA		B		
B-			B3			B-	UA	
CCC+	UA		Caa1			CCC+		

Source: Bloomberg

How will yields react to the fiscal development?

It seems that fiscal performance will have a much bigger impact on sovereign spreads than in previous years. Given the substantially reduced vulnerability of the Hungarian and Romanian currencies and the fiscal consolidation already put in place, central banks can continue with monetary easing, triggering further compression of yields. Romanian government bonds offer one of the highest yields, while there are high chances for a credible reduction of the country's deficit, as it has one of the lowest public debts in the EU. We expect yields on Romanian government bonds to decline from today's 8% towards 6.5% in summer this year. In Hungary, a country with one of the lowest deficits, the yields might drop from the current 7% towards 6% by year-end. However, we favor Romanian bonds, as the RON is currently one of the least volatile currencies in the region and Romania is less sensitive to global sell-offs (as the amount of bonds held by non-residents is significantly lower than in Hungary).

For Polish yields the risk scenario might be a higher bond supply or if the appreciation potential of the zloty fades away. This might happen if the government fails in its privatization plans or does not succeed in fiscal consolidation. Another risk factor for Polish T-bonds is the much lower liquidity surplus of local banks compared to regional peers' and thus the lower capacity of Polish banks to absorb a higher supply of bonds (without refinancing from the central bank).

Given the high net issuance of Czech and Slovak government securities, yields face an upward risk if sentiment towards CEE worsens. The liquidity surplus of Czech banks is relatively high, which might help to absorb heavy supply, but Slovak banks are already full of government securities (20% of total assets), as they already moved their free liquidity into government bonds after joining the Euro Area.⁹ This leaves financing of new Slovak debt more dependent on demand from non-residents and refinancing from the ECB.

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⁹ Currently, Slovak banks are net borrowers from the ECB, obviously playing on opportunistic carry trades like other Euro Area members (refinancing via the ECB and purchasing eligible government bonds with higher yields).

Special Report – Fiscal situation in CEE countries

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