Central Europe
From Transition to EU Membership

The Central European countries have made considerable progress with the transition to a market economy and now face the challenge of developing macroeconomic policy frameworks on the road to EU accession.

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THE COUNTRIES of Central Europe—the Czech Republic, Hungary, Poland, Slovakia, and Slovenia—are among the more advanced transition economies. They are a diverse group, with per capita incomes ranging from \$3,500 in Slovakia to \$9,900 in Slovenia, different industrial structures, and varying degrees of openness to trade. As they prepare to join the European Union (EU), they face a dilemma in developing viable medium-term macroeconomic policy frameworks. A key role of their monetary and fiscal frameworks will be to ensure low inflation and manageable fiscal deficits and, generally, to anchor expectations and foster stability. But these frameworks will need to cope with the challenges and uncertainties of real convergence with the EU countries, high and possibly volatile capital inflows, and financial sector change, all of which complicate policy formulation.

Building on past success

The transformation of the Central European economies over the past decade has been radical. The private sector's share of GDP has increased to 60 percent or more. Two-thirds of these countries' exports are sold in EU markets, and the European Union provides two-thirds of their foreign direct investment inflows. Inflation is in, or close to, single digits. External debt is low or declining, and the international reserve cover of central banks is generally strong. A key in the most successful countries—Hungary and Poland—has been the meshing of macroeconomic and structural adjustment: imposing hard budget constraints on firms, freeing prices, opening trade, and reforming the financial sector.

Progress on structural reforms has been uneven, however. For example, Hungary and Poland have made striking headway in dealing with quasi-fiscal liabilities. This is less the case for the Czech and Slovak Republics. Industrial restructuring is largely complete in Hungary, but the other Central European countries lag behind. All of the Central European countries still have much to do in reforming the public sector, improving infrastructure, and protecting the environment.

Challenges en route

Structural reforms in the Central European countries will therefore need to continue, although to different degrees. Because of their proximity to EU markets and the relatively high real rates of return on investment, further restructuring will likely take place in circumstances in which these economies are benefiting from sizable inward investment, all the more so as approaching EU accession engenders confidence in them—not to mention the expected benefits of accession itself. However, capital inflows can be expected to complicate the conduct of monetary and fiscal policies, either by putting unwanted upward pressure on inflation and exchange rates or by causing excessive external current account deficits—all of which would require a policy response. More generally, high productivity growth in the traded goods sectors, in addition to general structural changes, may result in pressures for real exchange rates to appreciate. This would imply that these economies cannot simultaneously achieve both convergence to very low inflation rates and nominal exchange rate stability. Depending on the scope of structural reforms and infrastructure improvements, policy in some countries may also come up against early overheating in their more advanced regions.

Changes in the financial sector will also affect policy frameworks. The financial sector plays a special macroeconomic role for four reasons: a financial crisis can cause major economic disruptions and sizable fiscal costs; banking resilience is crucial for a flexible interest rate policy and predictable and effective monetary transmission; efficient intermediation is essential for enhancing growth; and good risk management, by limiting unhedged borrowing and discouraging flows driven by moral hazard, helps to minimize potential problems from inflowing, potentially reversible capital.

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Monetary and exchange rate policies

At present, the exchange rate and monetary policy regimes of the Central European countries differ. These regimes now include inflation targeting in the Czech Republic and Poland, with Slovakia moving in that direction; monetary targeting in Slovenia, with short-term capital controls intended to reduce exchange rate volatility; and a crawling peg and narrow-band arrangement in Hungary, supported by controls on short-term capital. Indeed, even when these countries adopt the wide bands of the exchange rate mechanism of the European Monetary System (±15 percent around a fixed central rate under ERM2), they may opt for differing degrees of flexibility within the band.

The merits of different regime options are still being debated in academic and official circles, but three issues are always relevant in formulating monetary policy. First, it is important to ensure that the regime will be consistent with inflation objectives. This involves deciding whether real currency appreciation is to be absorbed by allowing the currency to appreciate in nominal terms or by allowing prices to rise. Second, the changing structure of the financial sector and shifts in money demand make the choice and use of nominal anchors for monetary policy more difficult, in part because the transmission mechanism may be unpredictable, complicating inflation- and monetary-targeting regimes. Third, and more fundamentally, in the presence of potentially strong and variable capital inflows, monetary policy cannot, by itself, foster the degree of real exchange rate stability that would be desirable to ensure a fairly smooth path for output and expectations. Other measures are key to minimizing the risks of a bumpy ride for the real economy: first, ensuring the health of the financial sector—minimizing distortions, including implicit guarantees, that could encourage unwanted capital inflows, and allowing monetary policy to operate flexibly; and, second, developing sound management of fiscal policy to help the country cope with variable capital inflows. Absent these measures, neither fixed nor floating exchange rate regimes will deliver the best possible economic performance.

Fiscal policy

Several factors complicate the design of fiscal policy. First, in some countries, significant restructuring costs still have to be absorbed by public finances, and the cost of reforms in public services, such as health care, could be substantial. Countries will also have expenditures associated with the adoption of the *acquis communautaire*—the European Union's laws and institutions. Second, the fiscal impact of public sector reform is hard to quantify, making it difficult to set appropriate spending ceilings; and fiscal decentralization—despite its possible advantages—also complicates expenditure control. Third, although taxes on labor are typically too heavy, there is uncertainty about how fast the total tax burden on the economy can realistically be cut. Fourth, if private saving does not increase in parallel with private investment, public saving will have to increase to relieve pressure on external current accounts. There is a general question of how far fiscal policy may be called on to limit the size of external current account deficits, particularly if monetary policy is directed to lowering inflation.

The following six steps can help in designing a sound fiscal framework (see box for an application to Hungary):

• determining whether the binding constraint on the fiscal deficit is external current account financeability or public debt sustainability, including, for example, contingent fiscal liabilities;

• developing a medium-term fiscal deficit path based on prudent assumptions about growth and the private saving–investment balance;

• identifying spending that is precommitted or that cannot be curtailed in the near future (such as interest on debt and pension payments);

A Fiscal Case Study: Hungary

Drawing on the priorities of Hungary's medium-term fiscal framework—which was sent last year to the Hungarian parliament for information—we can illustrate how the six steps described in the text are useful in designing fiscal policy.

• Hungary's public debt ratio—about 60 percent of GDP—is on a declining trend. On a saving-investment basis (using the European System of Accounts), the primary surplus was about ¾ of 1 percent of GDP in 1999 (a surplus of about ¼ of 1 percent would stabilize the debt ratio). Hungary has largely eliminated its quasi-fiscal deficit and contingent liabilities (except for health care costs linked to the aging of the population, which will have to be addressed through structural reforms).

• Hungary's external current account is the more binding constraint. The government aims to reduce external debt from its current level (close to 60 percent of GDP on a gross basis, about 25 percent on a net basis). With foreign direct investment inflows of some 3 percent of GDP, Hungary's current account deficit would have to be held more or less at its current level—about 4 percent of GDP—to limit net borrowing.

• With the risk of some deterioration in the private saving–investment balance—and hence the current account—over the medium term, a prudent strategy would be to strengthen the fiscal position by about 1 percentage point of GDP—raising the primary surplus, on a saving-investment basis, from ¾ of 1 percent of GDP to perhaps 2 percent of GDP. Assuming pension reform is completed and various public expenditures are included in the budget, the implied fiscal deficit would be just under 2 percent in 2002—at the lower end of the government's medium-term range.

• A significant portion of Hungary's public expenditure is strongly precommitted, implying an element of rigidity over the medium term. For example, annual interest payments exceed 5 percent of GDP (although they are declining), and pensions are about 8 percent of GDP.

• In terms of reform costs, it would be desirable to raise spending on infrastructure to enhance growth and accelerate the integration of the country's eastern and southern regions. This might entail raising government capital spending from just under 3 percent of GDP in 1999 to at least 4 percent of GDP. The cost of enterprise restructuring has been almost entirely absorbed. Other main issues include designing health care reforms with care, to contain inevitable short-term cost increases, and restraining spending by local governments. It would also be desirable to cut taxes by at least 1 percentage point of GDP, in addition to some EU-related excise cuts.

• If the fiscal deficit is to be cut to less than 2 percent of GDP, reform costs accommodated, and the tax burden lightened, other discretionary spending, which amounted to 23½ percent of GDP in 1999, needs to be curbed. Based on present policies, such spending could grow annually by 2½ percent in real terms, but, to make room for reform costs, it will essentially have to be frozen. There is scope for cutting back, because Hungary's public sector is large for a country at its level of development. Indeed, the 2000 budget foresaw a real cut in discretionary spending.

• Finally, what about uncertainty? These projections are based on fairly conservative macroeconomic assumptions: annual GDP growth gradually rising to 5 percent and a deterioration of 1 percentage point of GDP in the private saving–investment imbalance. If the balance of risk is on the upside, deeper tax cuts can be contemplated. However, if macroeconomic trends—say, slower growth or lower domestic savings relative to investment—give rise to greater tensions, or if there is slippage in spending, either capital spending or net tax cuts will have to be delayed. (A case can be made for delaying tax cuts to ensure that the infrastructure to support growth and EU accession is in place.)

This box is based on Craig Beaumont, 2000, "Managing Medium-Term Fiscal Challenges in Hungary," IMF Staff Country Report No. 00/59, which is available on the IMF's website at http://www.imf.org.

• building in the estimated costs of reforms in the real economy, the financial sector, and the government; taking into account the extent to which they add to the public debt or affect the saving-investment balance; and assessing the costs of infrastructure improvements and a phased approach to environmental policy;

• setting limits on discretionary public spending that are consistent with deficit goals and that may make it possible to reduce tax burdens; and

• developing realistic approaches to handling uncertainty in macroeconomic trends and reform implementation.

Even in a country as advanced as Hungary, the authorities' goals for fiscal policy—achieving the fiscal deficit target, reducing the tax burden, ensuring adequate capital expenditure, and completing needed reforms—could well come into conflict with each other. Although the other Central European countries have public debt ratios well below Hungary's, they also have large current account deficits or quasi-fiscal liabilities that will constrain fiscal policy over the medium term.

The limitation of a purely annual approach to fiscal policy is that it provides policymakers with less opportunity to manage resources strategically, and there is a risk that capital spending will be squeezed from year to year. The step-by-step approach to fiscal analysis outlined above, however, is flexible. It could be applied differently, depending, in part, on how advanced a country's structural transformation is. In countries where uncertainty is very high, this approach represents a tool for identifying medium-term tensions, even though expenditure budgeting will almost certainly focus mainly on the year ahead. When fiscal costs are analytically more tractable, a framework of this kind can be used to develop medium-term expenditure projections on a rolling basis, while allowing policymakers to try to limit base drift. As the Central European economies advance, they may be able to adopt full-fledged medium-term budgeting, as practiced in a number of advanced economies, including Finland, the Netherlands, and the United Kingdom.

Postscript

Although the policy challenges facing the Central European countries are daunting, they are manageable. Many EU members have faced and overcome similar challenges. Several entered the European Union—if not European Economic and Monetary Union—with large heavy industries that were state owned and unrestructured. Some experienced considerable stress in reducing their fiscal deficits to 3 percent of GDP and managing their exchange rates within a reasonable band during times of strong capital flows. Most EU members are still struggling with large contingent liabilities stemming from the prospective impact of population aging on health care and pension systems. Thus, many of these challenges are not transition issues, strictly speaking, so much as transformation challenges for these countries at an advanced stage on the road to EU membership. F&D

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